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American Institute of Certified Public Accountants. Stockbrokerage Auditing Subcommittee

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**AICPA
Audit
and
Accounting
Guide**

AUDITS of BROKERS and DEALERS in SECURITIES

With Conforming Changes as of May 1, 1994

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With Conforming Changes as of May 1, 1994

This edition of the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, which was originally issued in 1985, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in appendix F of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

American Institute of Certified Public Accountants

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Stockbrokerage Auditing Subcommittee on the application of generally accepted auditing standards to audits of financial statements of brokers and dealers in securities. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for brokers and dealers in securities. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

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 Accounting Standards Division

Preface

This audit and accounting guide has been prepared to assist the independent auditor in auditing and reporting on financial statements of brokers and dealers in securities. Generally accepted auditing standards are applicable in general to audits of financial statements of brokers and dealers in securities. This guide does not address the general application of those standards; rather, it focuses on special matters unique to auditing and reporting on such financial statements. The guide describes the conditions or procedures unique to the industry and illustrates the form and content of broker or dealer financial statements and related informative disclosures. Included are a discussion of brokerage transactions, accounting records, internal control structure policies and procedures for safeguarding customer assets involving securities and commodities, unique aspects of the audit, and illustrations of various financial statements and independent auditors' reports; however, detailed internal control structure questionnaires and audit programs are not included. This guide is a complete revision of the 1973 AICPA Industry Audit Guide, *Audits of Brokers and Dealers in Securities*, including the 1976 Statement of Position of the same title.

The form of financial reporting of brokers or dealers, in accordance with requirements established by the regulatory or self-regulatory bodies, is intended to meet the needs of customers who do business with these securities concerns; the needs of regulatory bodies and lenders; and, in the case of firms with public ownership, the needs of stockholders.

Most brokers and dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Some brokers and dealers are also futures commission merchants for commodity futures and commodity option contracts subject to regulation under the Commodity Exchange Act. Those that are members of the National Association of Securities Dealers, Inc. (NASD) or the National Futures Association (NFA) are subject to the rules of those associations, and those that are members of securities or commodities exchanges are also subject to the rules of such exchanges. Some of these rules, as currently in effect, are discussed in this guide. However, changes in the rules, regulations, practices and procedures of the securities and commodities futures industries have been frequent and extensive in recent years. *The independent auditor should keep abreast of such changes.*

This publication is only a guide in determining the scope of the work for each individual audit. It is not intended to limit or supplant individual judgment, initiative, imagination, and vigilance. Programs for each audit should be designed to meet the requirements of the particular situation, giving careful consideration to the size and type of organization and the internal control structure; this is a matter that should be determined by the exercise of professional judgment in light of circumstances present in a particular case.

Finally, users of this guide should be aware that certain issues affecting brokers and dealers in securities have not been included in this guide or are currently under study. Such issues include expanded guidance on interest arbitrage activities; certain aspects of hedge accounting applicable to brokers and dealers in securities, specifically, a reconsideration of the accounting for repurchase agreements; definitions of fixed income securities and methodologies for valuing them; and detailed guidance related to options on securities other than equity securities. As these issues are resolved, amendments to the guide may be issued.

Transition and Effective Date

Generally accepted accounting principles applicable to business entities in general are applicable to brokers and dealers in securities. Accordingly, the accounting principles established by pronouncements of the Financial Accounting Standards Board and its predecessor bodies of the American Institute of Certified Public Accountants are applicable to brokers and dealers in securities. The accounting provisions of this guide, except for the accounting for forward transactions, are effective for annual fiscal periods beginning after December 15, 1984.

Specific guidance on the accounting by brokers and dealers in securities for all futures transactions is included in FASB Statements No. 52, *Foreign Currency Transactions*, and No. 80, *Accounting for Futures Contracts*. Specific guidance on the accounting by brokers and dealers in securities for forward transactions had not been established before the issuance of this guide, except for forward exchange transactions as set forth in FASB Statement No. 52. This guide establishes that all other forward transactions should be marked to market currently, with the effect recorded in the statement of income, and, as with futures contracts, the nature of such forward commitments should be disclosed in the notes to the financial statements of brokers and dealers in securities. This guidance is effective for annual fiscal periods beginning after December 15, 1985.

A change in accounting principles resulting from the adoption of the new treatment for forward transactions should be applied retroactively, if material. And, to enhance comparability between periods, financial statements presented for prior periods affected should be restated to the extent practicable to give retroactive effect to such adjustments. If retroactive restatement of all years presented is not practicable, the financial statements presented should be restated for as many consecutive years as practicable and the cumulative effect of applying the change should be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect should be included in net income in the year the new treatment is first adopted. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes*.) The effect on income before extraordinary items, net income, and related per share amounts of applying the new treatment in a year in which the cumulative effect is included in determining that year's net income should be disclosed for that year.

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Chapter 1

General

1.01 Securities brokers and dealers perform various functions within the securities industry. Brokers, acting in an agency capacity, buy and sell securities and commodities for their customers and charge a commission. Dealers or traders, acting in a principal capacity, buy and sell for their own account and trade with customers and other dealers.

1.02 Although buying, selling, and settling accounts are usually relatively simple functions in other industries, for brokers and dealers in securities they may become complicated by many intermediate steps that occur between the receipt of an order and the completion of a buy or sell transaction.

1.03 In addition to buying and selling securities and commodities, securities brokers and dealers may underwrite or participate in the underwriting of securities, assist in the private placement of securities, offer investment advisory services, extend credit to customers who have purchased securities on margin, and act as a depository in holding securities owned by their customers. Securities brokers and dealers may market investments such as oil and gas and real estate participations, livestock programs, and equipment leasing ventures, all of which are highly specialized investment activities.

1.04 The language of the securities industry includes many specialized terms, and familiarity with these terms is essential to the independent auditor contemplating an audit of the financial statements of a broker or dealer. A glossary of those terms frequently encountered is included in this guide.

Rules Applicable to Brokers and Dealers in Securities

1.05 Brokers and dealers in securities are regulated primarily by the Securities Exchange Act of 1934 (the '34 act). The principal purpose of the '34 act was to regulate securities exchanges and over-the-counter markets operating in interstate, foreign, and through-the-mail commerce to prevent inequitable and unfair practices on such exchanges and markets.

1.06 The Securities and Exchange Commission (SEC) in recent years has greatly expanded its involvement in broker and dealer activities in an effort to have all brokers and dealers operate under uniform rules. Certain rules under the '34 act have been revised (for example, the Uniform Net Capital Rule) and a number of interpretations of the rules have been issued.

1.07 The Securities Act Amendments of 1975, among other matters, established a requirement for municipal securities dealers to register with and come under the regulatory authority of the SEC. The municipal dealers industry, working with the SEC, established the Municipal Securities Rulemaking Board (MSRB), which has the primary rulemaking authority, subject to SEC oversight, for securities dealers whose only transactions are in municipal securities.

1.08 Independent auditors should be familiar with the following, as well as other, SEC rules:

- 8c-1 and 15c2-1, concerning fraudulent practices and hypothecation of customers' securities
- 15c3-1, regarding the Uniform Net Capital Rule
- 15c3-3, concerning the maintenance of a reserve bank account for the exclusive benefit of customers and the requirement to obtain

possession or control of customers' fully paid and excess margin securities

- 17a-3, regarding records to be maintained
- 17a-4, describing retention of records
- 17a-5, concerning auditing and reporting requirements
- 17a-11, involving notification concerning violations of SEC rules
- 17a-13, concerning quarterly security counts, verifications, and comparisons

1.09 In addition to these rules, the independent auditor should be familiar with Regulations G, T, U, and X of the Board of Governors of the Federal Reserve System and, if the client is a member of a securities exchange or the National Association of Securities Dealers, Inc. (NASD), with the pertinent rules of those organizations. Rule 431 of the New York Stock Exchange, concerning margin accounts and transactions, is of particular importance. The independent auditor should also review the applicable financial reporting releases and other releases published by the SEC.

1.10 Effective January 1, 1976, the SEC amended rule 17a-5 and adopted a new financial and operational reporting system for brokers and dealers in securities. The new reporting system, Financial and Operational Combined Uniform Single (FOCUS) report, was designed to eliminate duplicate reporting of information to the SEC and self-regulatory organizations. The FOCUS report supersedes various financial and operational forms and reports previously required by self-regulatory organizations. It allows brokers and dealers to file one series of reports monthly, Part I of FOCUS, if required, and quarterly, Part II or Part IIA of FOCUS, depending on their type of business.

1.11 Under SEC rule 17a-5, an independent auditor is to report on the financial statements prepared in conformity with generally accepted accounting principles. Since brokers and dealers operate in fiduciary capacities, financial stability is considered to be of utmost importance. For this reason, emphasis is placed on the protection afforded customers who entrust money and securities to a broker or dealer. Thus, the independent auditor also is to report on supplementary schedules required by rule 17a-5 involving computation of net capital pursuant to rule 15c3-1, computation for determination of the reserve requirements pursuant to exhibit A of rule 15c3-3, and information relating to the possession or control requirements pursuant to rule 15c3-3. As part of the annual audit, the independent auditor also must prepare reports on internal accounting control required by SEC rule 17a-5 and, if applicable, regulation 1.16 of the Commodity Futures Trading Commission.

1.12 In 1975 the SEC adopted the Uniform Net Capital Rule (rule 15c3-1) for all brokers and dealers, including members of certain designated national securities exchanges who previously complied with the net capital rule of such exchanges and who were therefore exempt from the SEC rule. This rule established certain minimum capital requirements and introduced an alternative net capital concept. In addition, the rule established debt-equity ratio requirements, criteria for satisfactory subordination agreements, and requirements pertaining to the consolidation of certain subsidiaries and affiliates for net capital purposes. The rule became applicable to certain brokers and dealers, such as municipal security dealers not previously covered by the prior net capital rules, and to certain registered traders and floor brokers.

1.13 As a means of increasing net capital, brokers and dealers frequently borrow cash or securities under agreements that subordinate such borrowings to claims of general creditors. The subordinated borrowings, if approved by the

designated examining authority, are includible as part of net capital under the net capital rules. The SEC has set forth criteria for such borrowings to qualify as net capital and has established the above-mentioned maximum debt-equity ratio.

1.14 The Securities Investor Protection Act of 1970, which established the Securities Investor Protection Corporation (SIPC), requires registered brokers and dealers, with few exceptions, to become members of SIPC and therefore subject to an annual fee assessment. The act provides the SEC with rulemaking authority over the custody and use of customers' securities and the carrying and use of customers' funds (credit balances). The act also requires that rules be established regarding the maintenance of reserves relating to customers' funds. Exercise of this authority led to the SEC's adoption of rule 15c3-3.

Brokerage Transactions

Transactions Executed on an Exchange

1.15 Transactions in securities executed on an exchange may be in *round lots* (units of trading, normally 100 shares as specified by the exchange that lists the security) or in *odd lots* (quantities less than one unit of trading).

1.16 Transactions in securities executed on an exchange are normally initiated by a customer communicating with a registered representative (salesperson or account executive) to request that a specified number of shares of a particular security be bought or sold at a stated price or at the current market price. Such an order is then usually communicated to the order room of the broker or dealer and then to its clerk who is stationed at one of the exchanges that trades the security. If the broker or dealer is not a member of the particular exchange or has no member on the floor, the order is relayed to a correspondent broker who executes the trade on the exchange.

1.17 In either case, the order, once conveyed to the floor of the exchange, is given by the order clerk to a representative who will attempt to execute it. Once executed, the details of the transaction (price, quantity, other broker with whom the transaction was consummated, and so forth) are reported back to the order room of the broker or dealer for transmission to the purchase and sales department. A confirmation of the trade is then prepared and sent to the customer.

1.18 Many of the exchanges have related clearing organizations. If a broker or dealer is a member, deliveries and receipts of securities and the related cash settlements are made through these clearing organizations. The clearing organization usually offsets transactions between members so that only the net transactions of a member require the physical movement of cash or securities each day. Most clearing organizations follow the practice of continuous net settlement, whereby each day the results of each broker's or dealer's transactions are netted against the prior day's balances. Brokers and dealers operating through correspondent brokers settle their transactions through these correspondent (clearing) brokers, who in turn settle the transactions through the clearing organizations.

Over-the-Counter Transactions

1.19 An offer to buy or sell an unlisted security may be executed by a broker or dealer entering into a transaction with another broker or dealer who makes a market in that security. Such transactions are executed and settled directly between the brokers or dealers or are cleared through a clearing organization.

1.20 In the case of unlisted securities and new issues, the broker or dealer may act for its own account (as principal) in a purchase or sale transaction with a customer or another broker or dealer. No commission is reflected on this type of transaction; instead, the broker or dealer realizes a profit or loss on the purchase or sale of securities.

Margin Transactions

1.21 Margin transactions apply to the purchase or sale of securities on other than cash settlement terms. A purchase on margin contemplates an extension of credit to the customer by the broker or dealer. The maximum amount of such credit is prescribed by Regulation T. If a broker or dealer borrows additional funds to make payment, it may pledge as collateral the securities purchased or other securities that it may rightfully hypothecate for such customers.

1.22 Additional margin deposits may be required (maintenance margin) if market fluctuations adversely affect the equity in the customer's account. Maintenance margin ordinarily is governed by the rules of the self-regulatory agencies (for example, rule 431 of the New York Stock Exchange) of which the broker or dealer is a member rather than by Regulation T. However, many brokers and dealers have self-imposed margin requirements that are more stringent than self-regulatory organization requirements.

Option Transactions

1.23 Options (referred to as *puts* and *calls*) give the holder the right to sell or buy a specified number of shares of stock (normally 100 shares) at a specified price within a specified time. A put option gives the holder the right to sell the stock; a call option gives the holder the right to buy the stock. A put option obligates the seller of the option to take delivery of the stock and pay the specified price to the owner of the option within the time limit of the option. A call option obligates the seller of the option to deliver the stock to the buyer of the option at the specified price within the time limit of the option, if the option is exercised.

1.24 Listed options have gained wide recognition and are traded actively on several exchanges. Unlisted options on equity securities have been infrequently written and sold since trading in listed options began; those that are written and sold are customarily handled by the National Put and Call Association. Whether an option is exercised obviously depends on market conditions. Exchange-traded (listed) options are exercised less frequently than unlisted options because the purchaser or writer of listed options has the ability to enter into a closing or contra transaction. (Listed and unlisted option transactions are discussed in chapter 6.)

Arbitrage Transactions

1.25 The common definition of arbitrage is "the simultaneous purchase and sale of the same or equivalent security in order to profit from price discrepancies." Although the definition is by no means inaccurate, it is incomplete in today's securities market. There are two broad categories of arbitrage: basic arbitrage and risk arbitrage.

1.26 One type of basic arbitrage involves purchasing a security in one market and simultaneously selling the identical security at a profit in another. The price difference normally is not large and the risk is minimal. Another type of basic arbitrage involves purchasing and selling similar securities in like markets. Convertibles and when-issued securities are of prime interest to the arbitrageur.

1.27 Risk arbitrage is based on activities such as mergers, reorganizations, recapitalizations, tenders for cash, and tenders for securities.

1.28 Mergers. Mergers offer the greatest opportunity for arbitrage profit because of the uncertainty of consummating and the complicated proceedings necessary to complete a proposed merger. Concentrated arbitrage positions in unsuccessful mergers can result in losses.

1.29 Reorganizations. The number of reorganizations in recent years has been limited, occurring primarily in the event of bankruptcy or as a means to avoid bankruptcy. A reorganization in its most common form calls for issuing securities that are junior to the senior security holders and perhaps eliminating the common stockholder position.

1.30 Recapitalizations. Recapitalizations are also limited at the present time. In the past they were largely confined to public utilities. They generally include exchanges of debt for preferred stock and adjustments of arrearages on preferred stock by the issuance of debentures, arrear certificates, or common shares.

1.31 Tenders for Cash. In the usual tender for cash, a corporation makes an offer for a specific minimum number of shares of another company, reserving the option to accept all stock tendered over the minimum as well as a lesser number of shares. Although the tender price is usually substantially above the current market price, there is the risk that none or less than all of the tendered shares will be accepted.

1.32 Tenders for Securities. Another type of tender is the offering of specific securities and cash in exchange for the securities of another corporation. The number of tendered shares may be limited; in addition, certain market values are usually placed on the shares being offered. If there is a material change in market value from the time the tender offer is proposed to the effective date, changes can be made in the number of shares exchanged, or the corporation making the tender may withdraw.

Underwriting Transactions

1.33 Corporations and governmental entities that desire to raise funds through the sale of securities normally engage securities brokers or dealers to underwrite the security issues on either a *firm commitment* or a *best efforts* basis. An underwriting group may also be formed on a *standby basis*, in which there is a commitment to purchase the securities if called on. When the transaction is on a firm commitment basis, the underwriter (or underwriters) agrees to purchase the entire security issue from the issuer for a specified price and then sells the securities to the public at a slightly higher price. On a best efforts underwriting, the underwriter agrees to sell as much of the issue as he can, normally with a minimum requirement to complete the underwriting.

1.34 Since the value of most new issues of securities and the liability for successful marketing are normally too great for any one broker or dealer to assume, group accounts or syndicates may be formed in order to spread the risk. Additionally, selling groups, which may include brokers or dealers other than members of the underwriting group, are sometimes formed in order to obtain wider geographical distribution of the new issue.

1.35 The liability of the underwriting group may be divided or undivided. If the liability is divided, each member of the group has a specified maximum liability to purchase a certain number of shares of stock or principal amount of bonds. If the liability is undivided, each member of the underwriting group has a designated percentage liability for unsold securities in the underwriting account.

Private Placements

1.36 Brokers and dealers may also arrange the private placement of securities by issuers. A private placement does not involve a public offering and is not required to be the subject of a registration statement filed with the SEC. The securities involved in private placements can be either an initial issuance or a resale of previously issued securities and generally are restricted as to subsequent sale. For example, they may require registration under state and federal securities laws. The company's history, size, stability, and cash needs are factors in determining when the use of a private placement of debt or equity securities might be preferable to registering securities for sale to the public. In many instances the expertise of the broker or dealer may be essential in analyzing the company's activities and requirements in order to determine the type of securities to be offered and to assist in structuring the placement to enhance marketability. Private placements are often conducted on a best efforts basis by a broker or dealer, with maximum consideration normally given to locating an investor or a relatively small group of investors whose investment objectives closely parallel the expectations of the issuer.

Tax-Sheltered Investments

1.37 Brokers and dealers may also offer both public and private tax-sheltered programs. These investments are offered in a wide range of businesses and products, but common to all are the flow-through tax benefits inherent in the investment. Although the common investment vehicle for these programs has been the limited partnership, other legal forms have also been used. These investments are normally considered securities and may require registration under federal and state securities laws.

When-Issued Transactions

1.38 "When-issued" transactions are contracts to purchase or sell securities only when, as, and if new securities are issued. Brokers and dealers enter into such purchase or sale transactions on pending issues of new securities. These transactions may arise through underwritings, exchanges, mergers and so forth, after preliminary agreement to issue the securities is established but before a date for settlement has been set.

Delayed Delivery Transactions

1.39 Delayed delivery transactions are transactions by the broker or dealer for the purchase or sale of securities. They are similar in all respects to regular-way transactions (normal settlement) except that, by agreement, the date of consummation or settlement is extended.

Repurchase Transactions

1.40 A repurchase transaction, commonly known as a repo transaction, is a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price, which is generally the original sale price. Repurchase transactions may be made on an overnight or a fixed maturity basis or made with an agreement for the dealer to buy back the same or substantially identical security at an open date to be decided by the buyer and seller. A repo is not accounted for as a sale, even though the confirmation will read that the transaction is a sale subject to an agreement to repurchase the same or substantially identical securities. Securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales of trading or investment positions. Therefore, they should be reported with trading and

investment accounts, at market value, with the amount of the repurchase agreement reflected as a liability. Although the buyer receives many of the incidences of ownership of the securities, he is not entitled to the interest paid by the issuer of the security; instead, he receives interest on the money advanced for the purchase of those securities at a rate negotiated with the seller.

1.41 A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or substantially identical security at a definite price at a specific future date. For financial reporting purposes, the transaction involving the same or substantially identical securities is treated as a receivable collateralized by the security purchased, not as part of the buyer's trading or investment account.

1.42 A matched repurchase agreement occurs when a dealer buys a reverse repurchase agreement and simultaneously or shortly thereafter matches it with a repurchase agreement. The dealer makes a profit on the difference between the interest charged on the repurchase agreement and the interest earned on the reverse repurchase agreement. Matched repos may be executed for equal or differing amounts, with the dealer receiving more funds from the buyer than the amount being loaned to the seller. For financial reporting purposes, matched repurchase transactions should be recorded as both assets and liabilities on the statement of financial condition. Brokers or dealers may wish to disclose in the notes to financial statements the amounts of such matched repurchase agreements included in the statement of financial condition.

1.43 Government bond dealers who have large inventories to be financed find it advantageous to execute repos with institutional investors because a repurchase transaction usually has a lower interest rate than the government dealer loan interest rate. By using repurchase agreements, investors are able, with negligible market risk, to earn interest on their balances. The principal risk to the purchaser is the credit worthiness of the debtor.

Mutual Fund Transactions

1.44 Many brokers and dealers act as agents to offer their customers the opportunity to invest in mutual funds. Brokers act as agents for their customers by placing orders with the mutual funds. They may become involved in transmitting funds and in providing safekeeping for shares issued in certificate form. However, orders with mutual funds are often placed in the customers' names, the shares are held by the funds' custodians, and the broker's or dealer's only financial involvement is through receipt of commission checks if orders are placed with funds that charge commissions (*load funds*). Brokers also offer another service—the redemption of mutual fund investments owned by customers. Both the purchase and redemption procedures are often simplified by the absence of certificates reflecting the ownership of shares (*uncertificated* or *book shares*). Mutual funds or their transfer agents keep records of individual share ownership, including additions for the reinvestment of dividends and capital gains. Thus, certificates are not automatically prepared at the times of purchase but rather on request only, such as when a customer wishes to have a certificate reflecting ownership as collateral for a personal loan.

Refunding Governmental Bond Underwritings

1.45 A common type of underwriting involves the sale of bonds by a political subdivision, which uses the proceeds of the sale to retire an existing bond issue. A primary reason for issuing refunding bonds is to lower the

political subdivision's effective cost of carrying debt. To accomplish this, the subdivision invests the proceeds of the sale of the refunding bonds in high yield U.S. government securities that are placed in an irrevocable escrow and are scheduled to pay interest and to mature in time to retire the principal and interest on the initial bond issue. Thus, through a combination of possible lower interest rates on the refunding bonds and the high rate of yield on the U.S. government securities, the political subdivision can reduce the cost of its debt financing. Another reason for these underwritings may be to extend, defer, or realign the repayment of the original debt, since the proceeds of the refunding issue plus the investment return on the proceeds are sufficient to retire the existing issue, and repayment of the refunding issue would normally be due in serial amounts at later maturity dates than the original debt. This refunding concept also applies to corporate obligations.

Omnibus Account Transactions

1.46 An omnibus account is an account carried on the books of one broker or dealer (the clearing broker) representing the activity of customers' accounts or firm trading and investment accounts that are carried on the books of another broker or dealer (initiating broker). The clearing broker may have omnibus accounts on its books for several different brokers or dealers, each one treated as a separate and distinct account. Normally, the initiating broker deals with only one firm to clear and carry its customers' transactions.

1.47 Because of the large volume of transactions that may flow through an omnibus account, it is important that the clearing broker and the initiating broker reconcile such accounts frequently, preferably on a daily or weekly basis. The activity in the omnibus account is usually initiated when the initiating broker notifies the clearing broker of its firm trades or trades of its customers.

1.48 The clearing broker may perform a number of functions relating to the clearance and settlement of transactions (for example, receiving, delivering, transferring, or segregating securities) as instructed by the initiating broker. The initiating broker receives orders for its customers' securities transactions, prepares and sends confirmations and monthly statements to customers, and maintains customer accounts and margin records. Compensation of the clearing broker may be determined by a percentage of the commissions on the cleared transactions, a fixed charge based on the number of transactions cleared, a per item fee, an interest charge based on the average balance of the account, or any other method agreed to by the brokers.

Fully Disclosed Accounts

1.49 Fully disclosed accounts are the individual accounts of one broker's or dealer's customers (the introducing broker) carried on the books of another broker or dealer (the carrying broker). The carrying broker may maintain customers' accounts for several other brokers or dealers; an introducing broker generally would use only one carrying broker.

1.50 Activity in a fully disclosed customer's account generally begins with an order for a trade communicated by the introducing broker to the order room of the carrying broker. The carrying broker is then responsible for preparing and mailing confirmations and monthly statements, clearing and settling securities and money transactions, and maintaining detailed customers' ledgers, margin, and stock records. The customers are treated as if they were the carrying broker's own customers, except that correspondence to customers usually refers to the introducing broker by including a phrase such as "through the courtesy of..." The carrying broker is responsible for

complying with all regulatory requirements related to carrying and maintaining customers' accounts. The fees earned by the carrying broker generally represent a portion of the commission income generated in the account, or are determined by a fixed charge based on the number of transactions, by a per item fee, or by any other method agreed to by the brokers.

Accounting Records

1.51 The great majority of brokers and dealers record most securities transactions in the financial statements on the settlement date rather than on the transaction (trade) date. Settlement date accounting is used to provide additional time for the orderly settlement of transactions, including confirmation of trades, cash transactions with the customer, comparison with the clearing organization or the broker or dealer on the other side of the transaction, and delivery of the securities. Also, since the preponderance of transactions settle through clearing organizations, the broker or dealer is only obligated to the clearing organization (rather than to the brokers or dealers on the other side of the transactions) for the net settlement, which is not determined until settlement date; in addition, the resultant customer receivables and payables on settlement date are collateralized by the related securities. Another reason for the prevalent use of settlement date accounting is that it forms the basis of the rules and regulations of the SEC and other regulatory bodies that govern the industry. (See paragraph 2.10, "Settlement Date Versus Trade Date Basis Financial Statements," for a discussion of the implications on the financial statements.)

1.52 Brokers and dealers keep records in a variety of ways; some manually prepare records, while others employ computerized electronic data processing (EDP) systems that vary in degree of sophistication. In some systems the following items are recorded on magnetic tapes, discs, or other storage media until they are needed to produce reports: stock records, details of customer transactions, margin records, and, in many cases, the general ledger. In computerized operations there are certain master files (principally security files and customer files) that are used in conjunction with programs for each operation to process most of the work. The security files normally include CUSIP code numbers developed by the Committee on Uniform Security Identification Procedures to identify the security for machine processing, a sufficient description of the security to properly identify it in printed reports, and its *ticker symbol* (if one exists). The customer file normally includes the customer account number; a number to identify the salesperson who handles the account; an office number (if appropriate); the name and address of the customer; and, if desired, delivery instructions and names of those to whom additional copies of confirmations or statements should be sent.

1.53 Some brokers and dealers using fully automated record-keeping systems have acquired their own EDP equipment for in-house operations, thus necessitating the organization of an operations center and a systems department. Other firms use computer service bureaus.

1.54 Under a manual system the original source data (trade confirmations and information on cash receipts and disbursements and securities received and delivered) must be transcribed onto original entry journals or blotters. This is often done at the same time as the activity is posted to customer and broker statements or ledger cards. The stock record, normally a handwritten card maintained for each security, must then be posted individually. Because of the separate postings involved, the use of a manual system increases the possibility of posting errors.

1.55 SEC rule 17a-3 specifies the books and records that must be maintained and kept current. Rule 17a-4 specifies the period of time that the books and records maintained under rule 17a-3, as well as certain additional records, must be preserved. Rule 17a-13 requires quarterly securities examinations, counts, verifications, and comparisons with the records, and the recording of differences as well as appropriate documentation of such procedures. Also, in their constitutions and rules, the NASD and many securities exchanges require that members keep certain books and records. The prescribed records do not constitute an accounting system, but all accounting systems must include certain records that must be maintained on a current basis. Depending on the needs of the individual business, there are situations that may warrant the maintenance of certain additional records not specifically required under the rules of the various regulatory bodies.

1.56 When a broker or dealer operates as a sole proprietor, records must also be maintained of all assets and liabilities of the proprietor that are not related to the brokerage operation. Such records are necessary for determining whether the broker or dealer has complied with net capital requirements, which state that the excess of personal liabilities over assets not used in the business be treated as a deduction when computing net capital.

1.57 Financial Reporting Release No. 1, section 402.02, of the SEC provides general guidelines for maintaining current books and records in concordance with rules 17a-3 and 17a-4.

Blotter Records

1.58 The basic records of original entry maintained by a broker or dealer are sometimes referred to as blotters. The term *blotter* is used in the securities industry as the term *journal* is used in other industries. Specifically, the blotters serve to record the details of cash receipts and disbursements, purchases and sales of securities (by market), receipts and deliveries of securities, and other appropriate debits and credits such as listings of floor brokerage receivables or payables, mutual fund commissions earned, and investment counseling fees. Blotters and related records of receipts and deliveries generally indicate the money amount, quantity, description, and certificate numbers of securities.

Stock Record

1.59 The stock record provides a composite listing of the long and short positions of each security for which the broker or dealer is responsible. The position sheet for each security identifies each owner, holder, or party from whom a security is due. A long position in the stock record indicates ownership of the security or the right to possession. These may be customers; other brokers or dealers to or through whom a sale of securities, but not delivery, has been made; brokers and dealers or others from whom securities have been borrowed; or the broker or dealer itself, if it has purchased securities for its own account.

1.60 Short positions in the stock record indicate either the location of the securities or the responsibility of other parties to deliver them to the broker or dealer. Every security owned or held by the broker or dealer must be accounted for by its location (such as in the active box, the safekeeping or segregation box, or a branch office box) whether it is with a transfer agent or in transit between offices of the broker or dealer, or whether it is a stock loaned, held by a bank as collateral to a loan, or due from other parties. A short position is also used to reflect a broker's or dealer's short trading status in a security.

1.61 The long and short positions for each security must be in balance. In the event the total long and total short positions for a security are not equal, the amount required to balance is recorded in a difference account. Reasons for out-of-balance positions include a lag in the processing of one side of the transaction, miscoding the transaction or the other side of the transaction, misfiling a security movement ticket, or encountering problems relating to the receipt or delivery of securities. Brokers and dealers use difference accounts to help isolate problems for subsequent investigation. EDP programs used to prepare stock record reports are frequently designed to record any out-of-balance status in a difference account.

1.62 The speed and accuracy required to maintain comprehensive listings such as the stock record has led to the widespread use of EDP equipment. Moreover, EDP equipment has provided a greater latitude and versatility in obtaining information and recasting it in various formats. For example, data concerning customer securities required to be held in segregation or safekeeping may be shown on the same stock record by using an additional column or memo entry, thus eliminating the need for a separate listing or summary. The entire stock record generally is tabulated on a weekly basis, with changes tabulated on a daily basis.

1.63 Firms using manual systems normally maintain a separate record for each active security, filed alphabetically. Generally, the top portion of the ledger record is used to record activity and balances for long positions, and the bottom section is used to post short positions. Columns across the top of the page reflect stock record activity by date, with only the new balance of each long or short position affected by the transactions recorded on the card. The balance of all long versus all short positions should be checked periodically. This may be facilitated by transcribing all open positions to a current date (column). With a manual stock record, any out-of-balance condition noted and not immediately corrected must be set up in a difference account.

Depository Records

1.64 Depositories provide for physical custody and transfer of certain securities and the settlement of security transactions between brokers or dealers without the physical movement of securities. Securities held by certain depositories may be pledged to banks as loan collateral without the physical transfer of the securities to the banks. Such depositories include the following:

- Depository Trust Company (DTC)
- Pacific Securities Depository Trust Company
- Midwest Securities Trust Company
- Philadelphia Depository Trust Company

1.65 Each depository prepares daily reports for members indicating activity by security and the money balance on deposit. Monthly or weekly, each member receives a statement of the balance of all security positions.

1.66 Brokers and dealers have the responsibility of indicating in their records whether the securities held at a depository are available for use as collateral for bank loans or should be reduced to possession or control as required by SEC rule 15c3-3. The status of such securities may be indicated on a computer-maintained stock record or in separate records kept to support the total stock record position shown for a depository.

Continuous Net Settlement Records

1.67 The following are examples of clearing organizations that have been established to facilitate the settlement of security transactions:

- National Securities Clearing Corporation
- Stock Clearing Corporation of Philadelphia
- Pacific Clearing Corporation
- Options Clearing Corporation
- Midwest Clearing Corporation

1.68 Each clearing organization prepares daily reports for members showing the net security position (beginning balance plus sales and less purchases, plus receipts and less deliveries) by security and the net money balance that is due to or from the clearing organization.

1.69 Under such a system each broker or dealer deals directly with the clearing organization, and individual transactions in the same security are netted. This results in one position in each security (either to deliver or to receive) between the broker or dealer and the clearing organization. Money is paid or received daily by the broker or dealer, so that the money balance in the account equals the net market value of the open security positions.

Failed-to-Receive and Failed-to-Deliver Records

1.70 A fail-to-receive results from a transaction to buy securities from another broker or dealer. The securities are not received from the selling broker by the settlement date and show short on the stock record with a corresponding liability on the general ledger. A fail-to-deliver results from a transaction to sell securities to another broker or dealer. If delivery of the securities is not made to the buying broker by the settlement date, the trade shows long on the stock record with a corresponding receivable on the general ledger.

1.71 Normally, the cashier's department is responsible for open securities transactions with other brokers or dealers. Under a manual system the purchase and sales department may forward copies of trade confirmation tickets to the cashier's department. These tickets are filed by settlement date. If the security is not received or not delivered by the settlement date, the open tickets are transferred to the failed-to-receive or failed-to-deliver files. When the security is delivered or received, a copy of the confirmation ticket is sent to the accounting department as a basis for recording the security movement.

1.72 Some brokers and dealers develop fail items through a daily check of the various blotters. Under this system, for each fail the fail clerk prepares a memo slip indicating the date of the fail, the broker on the other side of the unit transaction, the number of shares, the description of the security, the unit price of the security, and the total dollar value of the transaction. The fail clerk usually keeps a file of fail slips in alphabetical order by security and by date of the fail. The securities and money balances listed on these slips or punch cards provide the supporting detail for the broker's or dealer's stock record fail security positions and for the general ledger fail money balance controls.

1.73 Brokers and dealers using some form of EDP equipment normally send a copy of the fail slip to the data processing department for recording the fail in the automated records. The data processing department processes each fail, with details of the transaction, and routes the information back to the fail clerk. The fail clerk will then control and monitor all open fail items.

1.74 In other data processing systems a punch card or other form containing similar information is prepared in advance of the settlement date for each transaction and is sent to the fail clerk. The transactions that clear on the settlement date are noted and cleared. The remaining transactions repre-

senting fails are forwarded to the data processing department for entry in the stock record (securities) and general ledger (money). The data processing department normally produces an updated file of open fails and forwards for the fail clerk. When a fail is cleared (securities having been either received or delivered versus payment), the fail clerk notes the date of the clearance and then routes the information to the data processing department so that the fail position may be cleared from the broker's or dealer's records. Some systems also use details of open fails to compare the cashier's department detail records to related stock record positions and general ledger money balances.

1.75 Some brokers and dealers record all fail transactions in a separate account for each broker or dealer with whom they execute transactions. These records are maintained as ledger accounts in the same form as the accounts maintained for customers. These individual accounts, reflecting only the net fails, must be broadened or grossed up for financial reporting purposes and for comparison with the lists of open fails-to-receive and fails-to-deliver.

1.76 Brokers and dealers clearing transactions through correspondent brokers normally maintain fail-to-receive and fail-to-deliver records only for transactions initiated by their trading departments with over-the-counter brokers or dealers. These records may be maintained in ledger accounts similar to those used for customers.

Securities Borrowed and Securities Loaned Records

1.77 Normally, details of securities borrowed from or loaned to others are recorded in a securities borrowed and loaned ledger or on individual securities borrowed and loaned information sheets. They also may be recorded in an account similar to that of a customer. The cashier's department records contain all applicable details of the securities borrowed and loaned transactions such as date, description of the security, quantity, total amount of the deposit made (securities borrowed) or received (securities loaned), and from whom they have been borrowed or to whom they have been loaned. As with failed-to-receive and failed-to-deliver items, these records will provide the supporting details for the securities record borrowed and loaned security positions, as well as for the general ledger money control of amounts due to and due from others in conjunction with these transactions. It is general practice for brokers and dealers to periodically adjust the contract value to market. In some cases U.S. government securities, letters of credit, and certain other qualified collateral may be used as collateral in place of a deposit of funds in connection with securities borrowed or loaned.

1.78 In automated systems, information may be prepared for each security borrowed and loaned position and retained in the cashier's department to be used as the basis for an out-of-loaned or out-of-borrowed entry and also in the comparison of cashier's department records with the stock record and general ledger for control purposes.

Collateral Loan Records

1.79 A separate record should be maintained in the cashier's department for each bank loan. This record should indicate the name of the bank, the dollar amount of the loan, and the interest rate. This record should also include the quantity, description, and market value of securities used as collateral for the loan. In certain EDP systems a separate file for securities used as collateral may be maintained in the cashier's department. The loan records or the file represent the supporting details of the general ledger dollar amounts and the security positions shown on the stock record as bank loan collateral.

1.80 When collateral loan securities are recalled from the bank or when additional securities are forwarded to the bank, either in substitution for securities recalled or as additional collateral, entries are prepared by the cashier's department and forwarded to the bookkeeping or data processing department for entry in the stock record.

1.81 In some systems, particularly EDP systems, separate accounts are maintained in the general ledger for each loan with separate positions being maintained in the stock record for the securities collateralizing each loan. In other systems, usually manual systems, the stock record may contain only one position for each security instead of a separate position for each loan.

Transfer Records

1.82 The cashier's department or margin department of a broker or dealer normally prepares written security transfer instructions on a multipart form. These instructions include the name in which the new certificates are to be registered (and the account number and mailing address if they are to be registered in a customer's name), the number of shares or principal amount and description of the securities, instructions indicating whether the new certificates are to be sent to the customer or held by the broker or dealer for the customer's account and certificate numbers of the securities being transferred. The instructions are sometimes separated between those covering securities to be transferred to the broker's or dealer's name or that of its nominee and those covering securities to be transferred to the customer's name. A copy of the instruction ticket is sent to the stock record department or to the data processing department to record the security as "in transfer" on the stock record. One copy of the instruction form is maintained in an open transfer ticket file that constitutes the supporting detail for the stock record transfer position. At least one additional copy of the instruction form is sent to the transfer agent with the securities to be transferred. In exchange centers such as New York, the broker or dealer normally prepares broker-originated window tickets for securities going to transfer. These tickets are numbered and are normally in triplicate. Two copies accompany the security going to transfer; the other is retained by the broker or dealer. The transfer agent returns one with the security and retains the other for reference purposes. The use of these tickets facilitates the proper identification of transfer items received from the transfer agent, and they allow the broker or dealer to question the transfer agent regarding specific items.

1.83 In manual accounting systems the securities received from transfer are matched against the open transfer instructions, and a copy of the completed instructions is used as the basis for removing the open transfer position from the stock record.

1.84 In EDP systems multipart transfer instruction forms and punched cards may be produced simultaneously for each security going to transfer. If such cards are prepared, they are maintained in the transfer department as an open-card file by security and by date of order. When securities are received from transfer agents, they are matched against the punch cards on file, and the cards are used as out-of-transfer entries. They are sent to the data processing department as a basis for removing open transfer positions from stock records. Those cards remaining in the transfer department provide the supporting detail for the transfer positions in the stock record.

Active Securities Records

1.85 Active securities are those used by the broker or dealer to carry out its daily business. These include customers' securities not paid for, securities

purchased by customers on margin with collateralized funds advanced by the broker against the purchase price, securities owned by the broker or dealer, and other proprietary securities.

1.86 Personnel in the cashier's department prepare records showing the daily movements in and out of the active box. Forms used for recording daily activity are normally referred to as *in-box sheets* and *out-box sheets*. At the end of each day, copies of these sheets are sent to the stock record department or to the data processing department as a basis for entries that reflect the security movement.

1.87 Some brokers and dealers use copies of the receipt and delivery tickets, in lieu of the in-box and out-box sheets, to notify the stock record department of the security movement.

Safekeeping and Segregation Securities Records

1.88 Safekeeping securities are customers' securities that are fully paid for and that are held in custody by the broker or dealer for the accounts of customers. Safekeeping securities normally are registered in the name of the customer.

1.89 Segregation securities also are securities set aside for customers who have fully paid for them, or securities of margin customers in excess of margin requirements. They are registered in the name of the broker or dealer. Although segregated securities may be identified specifically by customer, in most cases they are segregated in bulk on a fungible basis.

1.90 Securities usually are transferred to and from safekeeping and segregation on the basis of instructions prepared by the cashier's or margin department. The instructions reflect the customer's name, the quantity and description of the security, the date the instructions were prepared, and the customer's account number. If a multipart form is used as the instruction ticket, one copy is retained by the margin department and another copy is sent to the cashier's department. A copy may be forwarded to the stock record department or to the data processing department to record the security movement when changes take place in safekeeping or segregation securities.

1.91 In a nonbulk (specifically identified) system, the instruction ticket for moving securities into segregation or safekeeping is normally maintained in an open or pending file in the cashier's department until securities are received in proper form for placement into the vault. When the securities are received and placed in the vault, the instruction ticket is removed from the open file, and the certificate numbers and the date the securities were placed in the vault are recorded on the instruction ticket. Securities pending safekeeping or segregation (securities designated to be placed in safekeeping or segregation) may be failed-to-receive items, transfer items, or items located elsewhere such as in the active box, out on loan to another broker, or collateral for bank loans.

1.92 In some EDP systems the data processing department prepares listings based on into-segregation or into-safekeeping instructions issued by the margin department; in others, such listings are automatically generated by the system. The information is sent to the cashier's cage for use as the instruction to lock up the security, and may be sent to the margin department for subsequent use as release instructions. A copy of the original instruction is filed by the originating department, and an additional copy may be sent to the cashier's department to be attached to the securities as the customer identification for safekeeping and nonbulk (specifically identified) segregation.

1.93 In a manually operated system of bulk segregation the ownership of the securities usually is reflected in copies of the instructions filed in security order sequence by customer. A separate record is sometimes maintained for each security, showing the total number of shares or principal amount of bonds in segregation that should agree with the total quantities shown on the copies of the instructions and the segregation positions in the stock record. In automated systems the ownership of bulk segregation is usually indicated by means of additional columns in the stock record.

1.94 Brokers and dealers sometimes use another method of bulk segregation with EDP systems. Instructions for the segregation or release from segregation of securities are issued by the margin department. These instructions are processed into the broker's or dealer's stock record, and total customer segregation requirements are compared with the total quantity of specific securities presently in possession or control. This comparison generates a report to the cashier's department indicating, by issue, the number of shares pending that must be placed in segregation by the cashier or the number of shares in excess of requirements that may be removed from segregation by the cashier. The cashier's department carries out the instructions generated by this comparison, which should be produced on a daily basis by the data processing department. Since this bulk system does not relate certificates to specific customers, it is not feasible to determine, in the case of a pending segregation condition, the particular customer for whom segregation has not been accomplished.

Security Difference Records

1.95 Securities differences may be caused by inaccurate record-keeping on the part of a broker or dealer, by an out-of-balance condition in the stock record, or by errors in the receipt and delivery of securities. Such differences are normally disclosed through out-of-balance stock record conditions, periodic counts of securities on hand, and examination or confirmation of items such as transfers and fails.

1.96 When a security difference is disclosed, it should be recorded in a security difference account, pending research concerning the reason for the difference. When the difference is resolved, entries are made clearing the difference position from the stock record. If a short difference is not resolved after appropriate research, SEC rule 15c3-3 requires the broker or dealer to buy in the shortages. Subject to legal interpretation concerning ownership, the overages may be sold.

1.97 SEC rule 17a-13 requires that at least once in each calendar quarter, but not more than four months or less than two months apart, all positions in each security must be accounted for simultaneously, although not all securities must be accounted for at the same time. The broker or dealer must—

- Physically examine and count all securities held.
- Account for all securities subject to its control and direction, but not in its possession, by examining and comparing the supporting detail records with the appropriate ledger accounts.
- Verify (by communicating with the brokers or dealers, transfer agents, and so forth) all securities that have been subject to its control and direction but have not been in its possession for longer than thirty days.
- Compare the results of the count and verification with its records.
- Record within seven business days after each required quarterly security examination all unresolved differences in a security differ-

ence account setting forth the security involved and the date of comparison.

Cash Receipts and Disbursements Records

1.98 Checks or cash are received from customers, brokers, clearing organizations, and banks “over the window” by messengers, via the mail, and through wire transfers or drafts. Depending on the system, cash receipts may be recorded—

- By hand in a daily cash blotter.
- In a cash receipts journal by a bookkeeping machine.
- On a machine that types a receipt form and a paper punch tape that is used to prepare a daily cash receipts blotter.
- By the data processing department or computer service bureau from a marked copy of the confirmation.

1.99 Disbursements normally are made by check, draft, or wire transfers. Checks to customers are prepared on the basis of check requests received from the margin or cashier's department.

1.100 Receipts and disbursements for the day are totaled on the journals or blotters, and the closing balance for each bank account is determined. A summary of the postings is prepared showing the distribution to the control accounts in the general ledger. The summary is agreed with the totals of the various source documents and with related items in the summaries prepared by the receive and deliver departments. In addition to the settlement and cash journal summaries, brokers or dealers may prepare an overall summary of cash transactions processed by the cashier's department. Normally, this cash summary sheet contains numerous descriptive categories and columns to which the cash movements (totals) and settlement values of all security movements are posted. Entries are compiled by summarizing appropriate working documents, including blotters, journals, drafts, and various other receipt and disbursement forms.

Suspense Account Records

1.101 Suspense accounts in the brokerage industry may be of the purchase and sales (P&S) type or the operations type. If there is a cash receipt (representing a securities delivery) or a cash disbursement (representing a security receipt) but the related trade ticket has not been processed, an entry is made to the P&S suspense account rather than to an inventory, customer, or other house account. An entry is also made to a P&S suspense account when only one side of a principal party buy or sell trade ticket is processed. The P&S suspense account is relieved when processing of the trade ticket is completed and reflected in the appropriate account. An operations suspense account records unidentified cash receipts and differences in trade billings or cash settlements of trade tickets.

Margin Department Records

1.102 The margin department normally has the overall responsibility for the proper maintenance of customer accounts and controlling the extension of credit. Although the form of their records will vary, depending on whether the accounts are maintained manually or on computerized accounting systems, the information contained in margin department records is generally the same. Margin department records are posted from copies of transaction tickets received from the purchase and sale, cashier's, dividend, and accounting departments.

1.103 Records in the margin department will normally indicate for each margin customer the market value of the securities, the money balance of the account, the excess or deficit margin, the transfer, the safekeeping and segregation instructions, the pending trades, and the special miscellaneous account (SMA) balance calculated in conformity with Regulation T.

1.104 The margin department's principal function is to check the credit status of customers. It is responsible for initiating margin calls, maintenance margin calls, extensions of time for cash account customers to pay for securities purchased, and instructions for moving securities to or from safekeeping or segregation. The margin department also maintains copies of documents pertaining to these transactions.

1.105 Other records and information that may be maintained by the margin department are standing customer instructions regarding the delivery of securities, the disposition of cash from the sale of securities, or the receipt of dividends and interest and guarantees of customers' accounts.

Dividend Department Records

1.106 The dividend department is responsible for records pertaining to all types of distributions made on securities, including cash dividends, stock dividends, rights, and splits. It may also forward proxy material to customers.

1.107 On the dividend record date, listings are supplied to the dividend department showing the registered holders and locations of each security. The record will indicate how the securities are registered—that is, in the name of the broker or dealer; its customers; or another broker, dealer, or individual from whom the dividend must be claimed. In order to reduce the number of dividend claims, it is normal procedure for the dividend department to notify the cashier's department on a daily basis of securities approaching dividend record dates. The cashier's department will then check for securities on hand that are registered in a name other than its own and will attempt to deliver such securities to the transfer agent so that the registration may be transferred to its own name as of the record date. Brokers and dealers that have EDP systems may use magnetic tapes provided by dividend reporting services to identify record date information.

1.108 For each dividend distribution, the dividend department prepares a memo proof to ascertain the total receipts and disbursements that will be processed.

1.109 The dividend department instructs the accounting department or the data processing department which customers should be credited or charged for the dividend. The contra entry is made to a dividend receivable or payable account. Differences between the amount received and the receivable amount represent items that must be investigated by the dividend department.

1.110 The dividend department also maintains a record of securities that the broker or dealer is failing to receive or deliver on the dividend record date. Securities received or delivered against fails that were open on the record date and are in the name of the delivering broker should be accompanied by due bills. It is usually the responsibility of the dividend department to collect or authorize payments for transactions of this nature. Brokers and dealers should maintain dividend records for each security by individual declaration date and should not combine all dividends received for each security over a period of time. For example, Company X declares a dividend to holders of record on January 2 and later declares another dividend to holders of record on April 1. The broker or dealer may have a receivable of \$5,000 for the January 2 dividend but may have received \$5,500. This would indicate that the broker or

dealer was either failing to deliver and owes other brokers \$500, or that another broker should make claim for the \$500 for securities it is holding that are still registered in the broker's or dealer's name. For the April 1 dividend the broker or dealer may have a receivable of \$6,000 but may have received only \$5,200. The dividend department would have to determine which other brokers owed the \$800, either for securities that the broker or dealer had failed to receive or for securities not yet transferred into the broker's or dealer's own name from the name of the other brokers. The dividend record should show a payable of \$500 for the January 2 dividend and a receivable of \$800 for the April 1 dividend.

1.111 Dividends received that have not been paid or credited because proper account identification cannot be made are considered to be unclaimed dividends and normally are paid only upon receipt of valid claims. Balances remaining in dividends payable may be subject to abandoned property laws.

Customers' Securities Account Records

1.112 Separate accounts must be maintained for each customer, and a statement of the account must be sent to the customer at least quarterly, as required by regulatory bodies. Transactions in the accounts cover both money and positions, with the security transaction and related money generally recorded on the settlement date. The accounts should include an itemization of all purchases; sales; receipts and deliveries of securities; and all other debits and credits, including dividends and interest received or charged and investment counseling fees. The accounts are generally maintained so that money balances and security positions are clearly indicated.

1.113 A customer may have many different accounts that are subject to cash or margin regulations. Cash, margin, income, short sale, and other accounts are commonly encountered.

1.114 *Cash Account.* The cash account provides record of cash transactions expected to be cleared within the time limit prescribed by Regulation T. Cash account purchases are limited by Regulation T to purchases for which sufficient funds are held in the account, or in reliance on an agreement that the customer will promptly make full cash payment for the security, and that the customer does not contemplate selling the security prior to making such payment. Cash account sales are similarly limited to sales for which the security is held in the account or in reliance on an agreement that the customer owns the security and will make prompt delivery.

1.115 Normally, full cash payment must be made within seven business days after the date the security is purchased. Assuming a five-day settlement period, full cash payment must be made no later than two business days after the settlement date. However, if a customer purchases a security with the understanding that the security will be promptly delivered and that the full cash payment will be made promptly against such delivery (a cash-on-delivery [COD] or delivery-versus-payment [DVP] account), the time period for making payment is not to exceed thirty-five calendar days. Failure to make timely payment would ordinarily require the prompt cancellation or liquidation of the transaction. In exceptional cases, the seven business day and thirty-five calendar day periods may be extended for one or more limited periods by applying to a committee of a national securities exchange or to the NASD.

1.116 Historically, certain regulatory bodies have restricted the acceptance of sales orders, other than short sales, unless there was a reasonable prospect of making prompt delivery of securities against the sale. Prompt delivery was not defined in Regulation T or elsewhere. SEC rule 15c3-3 now

requires that if a security sold, other than a short sale, is not received from the customer within ten business days after the settlement date, the broker must immediately close the transaction by purchasing the related security for the account of the selling customer unless an extension is obtained. Certain municipal bonds are exempt from this buy-in requirement.

1.117 *Margin Account.* The margin account provides a record of purchase transactions for which the broker or dealer is expected to extend credit. The amount of credit extended is subject to the limits prescribed by Regulation T. This regulation establishes the maximum loan value of the securities in the account and requires the broker or dealer to obtain, as promptly as possible—within seven full business days following the date of the transaction—a deposit of cash or securities necessary to eliminate any margin deficiency. In exceptional cases the seven-day period may be extended for one or more limited periods by applying to a committee of a national securities exchange or to the NASD. Maximum loan values for securities are prescribed periodically by a supplement to Regulation T. In addition, certain securities exchanges have rules establishing minimum maintenance margin requirements. A broker or dealer may establish initial or maintenance margin requirements that are greater than those required by the rules of the regulatory bodies.

1.118 *Income Account.* The income account provides a record of interest and dividends received on securities maintained in other accounts.

1.119 *Short Sale Account.* Transactions in securities sold short are recorded in a short sale account. Such transactions are also governed by the margin requirements of Regulation T. On a short sale transaction the broker or dealer is expected to borrow the security on behalf of the customer for the purpose of satisfying the delivery requirement.

1.120 *Other Accounts.* Other special accounts are provided for (1) the purchase of securities through the exercise of rights or warrants; (2) transactions in exempted, municipal, and registered nonequity securities purchased on margin; (3) transactions in convertible debt securities purchased on margin that are convertible into stock held in a margin account or that carry a right to subscribe to or purchase such stock; and (4) option transactions. Regulation T prescribes different loan values and the length of time that credit can be extended in these accounts.

Trading and Investment Account Records

1.121 Trading securities are considered as inventory or stock-in-trade. Investment securities are purchased with the expectation of capital gain. To qualify for capital gain treatment under the present Internal Revenue Code, the broker's or dealer's records must clearly indicate, by the close of the day acquired (floor specialists have seven days) that the security is held for investment and not for trading purposes.

1.122 Brokers and dealers may purchase, for investment, securities that are not readily marketable or whose sale is restricted by the purchase terms. These securities should be recorded separately in the accounts of a broker or dealer and clearly designated.

1.123 The trading department maintains separate records on a trade date basis. It is important that the broker or dealer reconcile these records periodically with the accounting department records, which are normally maintained on a settlement date basis.

Underwriting Department Records

1.124 A broker or dealer that participates in underwriting activities normally will function as either the managing underwriter, a co-managing underwriter, or a participating underwriter. A managing underwriter, in addition to being a participating underwriter, normally negotiates the transaction with the issuer of the security and maintains the records of the underwriting group. A co-manager takes part in the negotiations but does not maintain the records of the group.

1.125 The managing underwriter maintains daily position listings of the entire issue and ascertains the status of securities subscribed to and whether they have been delivered to the participating underwriters. Expenses associated with each underwriting are accumulated in the general ledger in separate accounts. This process is referred to as "running the books." When the underwriting is completed, the profit or loss on the underwriting is determined and distributed to the participating underwriters.

1.126 The participating underwriters will maintain records of each underwriting participation only to the extent they are involved.

Commodity Department Records

1.127 The books and records maintained by brokers or dealers dealing in commodities include customer and firm positions and open commodity futures contracts. When a customer enters into a commodity futures contract, which is an agreement to buy or sell at some future date, he is sent a purchases-and-sales form. At that time, the broker or dealer records an accrual for the half-turn commission and the amount of any margin deposit made by the customer. In addition, a record in the form of a contract book is maintained by commodity and by maturity date and is also recorded on the customer statement. When an offsetting purchase or sale contract is made, the open trade in the contract book is so noted. In manual systems there is usually a separate page in the record for each commodity delivery month and space to note the completion of the transaction. In computerized systems listings can be made periodically in chronological order, and posting space and order requirements are rather flexible.

1.128 The commodity blotter is a record of the actual purchase or sale at the completion of what is called a *round turn*, which is a purchase or sale offsetting an existing open contract. In addition to entering a description of the transaction, the amount of the resulting gain or loss to the customer is recorded.

1.129 The contract position record is maintained on a daily basis showing the positions in each commodity carried for customers or for the broker's or dealer's own account. It shows a balancing of futures contracts by customers offset by the net position with the carrying broker or with the clearing association. Finally, there is a customers' commodity ledger that is used to record commodity transactions for each customer and carrying broker. Completed transactions, money, and contracts are posted daily from the regular blotter record of cash receipts and disbursements and the commodity blotter for gains, losses, and commissions. (See chapter 7 for a discussion of commodity transactions.)

SEC Rules 15c3-1 and 15c3-3

1.130 The broker or dealer is required to be in compliance with the net capital rule (rule 15c3-1) at all times. At least monthly a broker or dealer is required to prepare and maintain a record of the proof of money balances for

all ledger accounts in the form of trial balances and a record of the computation of aggregate indebtedness if applicable (unless the alternative capital computation is being followed which uses aggregate debit items from rule 15c3-3) and net capital under rule 15c3-1, as of the same date. In addition, rule 15c3-3 requires that records be maintained of the periodic (weekly or monthly) calculations of aggregate debit and credit items and the deposits required in the special reserve bank account for the exclusive benefit of customers and that compliance with the requirements for maintaining physical possession or control of fully paid and excess margin securities of customers be documented.

Chapter 2

Financial Statements and Reports

Financial and Operational Combined Uniform Single Report

2.01 On December 17, 1975, the SEC announced in Release No. 11935 under the '34 act, the adoption of the FOCUS report as the reporting system for brokers and dealers. This announcement had a significant effect on annual audits of brokers and dealers. It eliminated the Answers to Financial Questionnaire and replaced it with financial statements that present financial position, results of operations and cash flows in conformity with generally accepted accounting principles. The Answers to Financial Questionnaire was the annual report of financial condition previously required to be filed with the SEC by registered brokers and dealers.

2.02 The annual audited financial statements must be filed by every member of a national securities exchange who transacts business in securities directly with or for persons other than members of a national securities exchange, by every broker and dealer (other than a member) who transacts a business in securities through a medium of any member of a national securities exchange, and by every broker and dealer registered in accordance with section 15 of the '34 act.

2.03 Under the revised rules brokers and dealers are required to file financial statements in the form prescribed by the SEC at the end of each calendar quarter on part II or part IIA of the FOCUS report. In certain cases, such as when a broker or dealer exceeds certain parameters of financial and operational conditions, part II or part IIA must be filed monthly or weekly. In addition, audited financial statements are required to be filed on a fiscal or calendar year basis as of a date selected by the broker or dealer. The annual audit for subsequent years must be as of the same date unless the SEC issues prior approval for a change of the broker's or dealer's fiscal year.¹ If the broker or dealer selects a date for the annual audited financial statements that is other than the close of a calendar quarter, an additional unaudited Form X-17A-5, part II or IIA, of the FOCUS report must be filed by the broker or dealer as of the date of the annual audit.

2.04 SEC rule 17a-5 states that the annual audited financial statements are to include the following:

- Statement of financial condition
- Statement of income (loss)
- Statement of cash flows
- Statement of changes in stockholders' equity or partners' or sole proprietor's capital
- Statement of changes in liabilities subordinated to claims of general creditors

2.05 The contents of each of these statements are discussed in this chapter, and illustrations are presented in Appendix A of this guide. Brokers and dealers that have issued securities to the public are subject to the

¹ SEC rule 17a-5 defines *fiscal year* as the broker's or dealer's fiscal year for reporting purposes; the fiscal year is not necessarily the same as the tax year. For purposes of defining a time period such as fiscal or calendar quarter, the last Friday or last business day of such period is acceptable.

disclosure rules that apply to publicly held companies. Such rules require that comprehensive financial information be disseminated to stockholders, including statements of income and cash flows.

2.06 The annual audited financial statements should also contain the following supplementary schedules required by rule 17a-5 and regulation 1.16 of the Commodity Futures Trading Commission:

- Computation of net capital pursuant to rule 15c3-1
- Computation for determination of reserve requirements pursuant to rule 15c3-3
- Information relating to the possession or control requirements pursuant to rule 15c3-3
- Schedule of segregation requirements and funds in segregation pursuant to the Commodity Exchange Act
- A reconciliation between the computation of net capital under rule 15c3-1 and the computation for determination of the reserve requirements under exhibit A of rule 15c3-3 based on the audited financial statements and the corresponding computations included in the unaudited FOCUS filing or a statement that one is not necessary pursuant to rule 17a-5(d)(4)

2.07 Two copies of the annual audited financial statements must be filed with the SEC's principal office in Washington, D.C., and one copy with the appropriate regional office of the SEC and with the designated examining authority for the broker or dealer, no later than sixty days after the date of the financial statements. If required, an extension of time for filing can be requested.² It is also necessary to provide copies to all self-regulatory organizations of which the broker or dealer is a member and to the states in which the broker or dealer is registered.

2.08 All annual audited financial statements that are filed with the SEC will be treated as public documents. However, some degree of confidentiality may be achieved by filing two separate sets of financial statements. The set that will be treated as a public document need contain only the auditor's report, the statement of financial condition, the related notes, and the report on internal accounting control if that report discloses a material weakness or material inadequacy. (However, certain state regulations might differ from those of the SEC.) The second, complete set of financial statements should be marked "CONFIDENTIAL."

2.09 Rule 17a-5(e)(4) requires the broker or dealer to file a supplemental report on the status of its membership in SIPC. The auditor's review of the supplemental report should comply with certain minimum procedures as set forth in rule 17a-5(e)(4)(iii). This supplemental report is bound separately from the audited financial statements and is filed with the regional and Washington offices of the SEC, SIPC, and the designated examining authority. The SIPC report contains a schedule of assessment payments (showing any overpayments applied or carried forward), including details as to payment dates, amounts, and the name of the SIPC collection agent or, if exclusion from membership was claimed, details as to the filing of the form requesting

² The broker's or dealer's request for extension must be accompanied by a letter from the independent public accountant answering the four questions in SEC rule 17a-5 regarding extensions. Because three of the four questions are answered based on that part of the audit completed to date, if the accountant has not performed any significant audit work, he should so state in his letter accompanying the extension request. For further discussion see "Filing Reports" in paragraphs 4.61 through 4.62.

exclusion from membership. (See chapter 4 for a further discussion of the report to be rendered on the SIPC Annual Assessment.)

Settlement Date Versus Trade Date Basis Financial Statements

2.10 As discussed in the section of chapter 1 on accounting records, brokers and dealers generally use settlement date accounting. However, generally accepted accounting principles normally require that financial effect be given to transactions at the time an event takes place—that is, the time an entity acquires a resource from or incurs an obligation to others—which would make the use of trade date accounting appropriate. Thus, consideration should be given to the possible effect on the financial statements of unsettled transactions. The area of most concern is the income statement, which should include the effect of all transactions on a trade date basis. For example, accruals should be made for realized or unrealized gains and losses in securities purchased or sold for the broker's or dealer's account but not yet settled, and for commissions, net of related salesman's share, on unrecorded agency transactions. Other than for the commission accrued, gross receivables or payables related to unsettled agency transactions ordinarily are not shown on the statement of financial condition. However, accruals should be made in the statement of financial condition for the broker's or dealer's inventory positions that are expected to settle in the regular-way and for any other transactions with delayed settlements that are expected to be settled for cash in the future and that are not contingent (such as a when-issued or stand-by transaction). Because of the practical difficulty in identifying the offsetting entry to each such inventory position, a net receivable or payable may be accrued. Since future and forward inventory positions are not accrued as inventory positions in the statement of financial condition, disclosure of the nature of such transactions should be made in the notes to the financial statements; however, such positions would be marked to market and included in the income statement.

Financial Statements to Be Furnished to Customers

2.11 Within 105 days of its reporting year-end a broker or dealer is required to furnish the following information to each customer as defined in rule 17a-5:

- An audited statement of financial condition and related notes, which should be prepared in conformity with generally accepted accounting principles, including a note on the company's consolidation policy and a note indicating the amount of the broker's or dealer's actual net capital and the amount of required net capital.
- If material inadequacies were reported as a result of the most recent annual audit, the broker or dealer must indicate that a copy of the independent auditor's report on internal control is available for inspection at the SEC's principal and regional offices.³

2.12 A copy of the statement of financial condition sent to customers must be filed with the SEC's principal and regional office and with the designated examining authority.

2.13 Brokers and dealers are also required by the SEC to furnish each customer with an unaudited statement of financial condition dated six months

³ Material inadequacies and related considerations are explained in paragraphs 3.11 through 3.21, "Reporting on the Internal Control Structure by Independent Auditors."

after the date of the audited financial statements. The unaudited statement should conform to the audited statement with respect to presentation and disclosure requirements, and should be mailed within sixty-five days of the statement date.

FOCUS Financial Statements

2.14 Normally, annual audited financial statements are presented on a consolidated basis. The instructions for financial statements on Form X-17A-5, part II or part IIA, require that certain subsidiaries be consolidated if the broker or dealer has guaranteed, endorsed, or assumed the obligations or liabilities of those subsidiaries, and permit the consolidation of other subsidiaries. If, however, the effect of consolidating any subsidiary is to improve net capital or the net capital ratio computed pursuant to rule 15c3-1, the broker or dealer must obtain an opinion from legal counsel as of the date of the financial statements that the net assets of the subsidiary can be liquidated and distributed to the broker or dealer within thirty calendar days. Consolidating a subsidiary that improves net capital or the net capital ratio is not permitted unless such a legal opinion is obtained. If the statement of financial condition filed on Form X-17A-5, part II or part IIA, is not on a consolidated basis, it may differ from the statement reported on by the independent auditor. The SEC requires that such differences be disclosed in a note to the audited financial statements or included as supplementary information.

Statement of Financial Condition

2.15 The audited statement of financial condition must be in a format and on a basis consistent with the totals reported on the statement of financial condition contained in Form X-17A-5, part II or part IIA, as filed by the broker or dealer. Its presentation should conform with generally accepted accounting principles.

- Subordinated liabilities and stockholders' equity (or partners' or proprietor's capital in the case of a partnership or proprietorship) should be disclosed separately. However, it is permissible to present a combination of subordinated liabilities and stockholders' equity (an example of such a presentation is shown in the notes to exhibit B in appendix A) as long as the two components are clearly presented with a separate total of stockholders' equity and with appropriate descriptive captions that do not imply that subordinated liabilities are part of stockholders' equity. The principal reasons for allowing the combination are that the subordinated liabilities of a broker or dealer possess unique characteristics (for example, they must be approved for inclusion as regulatory capital by the broker's or dealer's self-regulatory organization, amounts may not be repaid if the repayment would reduce regulatory net capital below required amounts, six months' notice to the self-regulatory organization is required for accelerated withdrawals, and the initial term must be over one year) and the practice has been widespread, generally accepted, and well understood in the industry. In addition, due to these unique characteristics of subordinated liabilities, disclosure should be made in the footnotes to the financial statements or separate statement of financial condition of the amount of subordinated debt for which six months' notice has been given of intent to withdraw. Subordinated liabilities that have not been approved for inclusion as regulatory capital should not be included in a total

combining such liabilities and stockholders' equity. It should be noted that the SEC does not permit the combination of subordinated liabilities and stockholders' equity in any filings other than those made under rule 17a-5.

- The statement of financial condition, when presented with the other basic financial statements, should disclose the components of stockholders' equity (for example, preferred stock, common stock, and retained earnings).
- The statement of financial condition presented alone (for example, statement of financial condition bound separately for the SEC—see the discussion of confidentiality above) and the statement of financial condition furnished to customers (see paragraphs 2.11 through 2.13, "Financial Statements to Be Furnished to Customers") need not disclose the components of stockholders' equity.
- Current and noncurrent classifications ordinarily are not presented on the statement of financial condition. Such a distinction normally has little meaning for brokers and dealers.

Statement of Income (Loss)

2.16 The statement of income (loss) should be in a format that is consistent with a statement such as the one contained in Form X-17A-5, part II or part IIA, and should disclose separately the sources of the broker's or dealer's revenues, such as brokerage commissions, trading and investment profits or losses, underwriting profits or losses, fee income, dividends, and interest. Expenses should be reported by major types, such as employee compensation and benefits, communications, occupancy and equipment, interest, floor brokerage and clearance fees, and so forth.

Statement of Cash Flows

2.17 The statement of cash flows is required when financial statements present both the statement of financial condition and the statement of income (loss) in conformity with generally accepted accounting principles.

Statement of Changes in Ownership Equity

2.18 The statement of changes in ownership equity should be in a format that is consistent with a statement such as the one contained in Form X-17A-5, part II or part IIA. This statement is required whether the reporting broker or dealer is a corporation, partnership, or sole proprietor. It should disclose the principal changes in the equity accounts of the broker or dealer during the periods for which statements of financial condition are presented.

Statement of Changes in Liabilities Subordinated to Claims of General Creditors

2.19 The SEC requires a statement showing the increases and decreases to subordinated liabilities for the year, or alternatively permits the inclusion of the information in the notes to the financial statements.

Notes to the Financial Statements

2.20 In addition to other disclosures ordinarily required by generally accepted accounting principles, summary financial information concerning subsidiaries consolidated under the flow-through capital benefits of Appendix C of rule 15c3-1 and the effect on net capital and the required net capital of

the broker or dealer must be given in the notes to the statement of financial condition furnished to customers. Further, if accounts of other subsidiaries are consolidated in conformity with generally accepted accounting principles but are not permitted to be consolidated under FOCUS filing requirements, the SEC requires the disclosure of summary financial data for those subsidiaries, including assets, liabilities, and net worth.

FOCUS Supplementary Schedules

Computation of Net Capital Pursuant to Rule 15c3-1

2.21 This schedule shows the amounts necessary to determine the net capital and the required net capital of the broker or dealer. A reconciliation is required if material differences exist between the schedule reported on by the independent auditor and the broker's or dealer's unaudited filing of part II or part IIA of the FOCUS report. If no material differences exist, a statement indicating so must be made.

Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3

2.22 This schedule provides a comparison of customer-related credit balances, the short market valuation of certain customer-related accounts, and certain customer-related debit balances. If total credits, as defined by rule 15c3-3, exceed total debits, as defined by rule 15c3-3, a deposit in a special reserve bank account for the exclusive benefit of customers must be made. The SEC requires reconciliation of material differences between the computation included with the financial statements reported on by the independent auditor and the computation previously filed by the broker or dealer in the unaudited FOCUS report.

Information Relating to Possession or Control Requirements Under Rule 15c3-3

2.23 This schedule discloses the market value of securities required to be in possession or control that had not been reduced to possession or control in the proper time frame because properly issued segregation instructions were not acted upon or segregation instructions were not issued. Both the market value and the number of related security positions must be reported.

Schedule of Segregation Requirements and Funds in Segregation Pursuant to the Commodity Exchange Act

2.24 This schedule shows the computation of the amount of funds contained in customers' regulated commodity futures accounts that must be segregated pursuant to the Commodity Exchange Act and the total funds segregated by the broker or dealer to meet these requirements.

Financial Statement Account Descriptions

2.25 Many items set forth in the illustrative financial statements contained in Appendix A are self-explanatory. The captions in the following paragraphs require special comment.

Cash

2.26 Cash in banks subject to withdrawal restrictions, restricted deposits held as compensating balances, or cash segregated in compliance with federal or other regulations (such as cash required to be segregated under the Commodity Futures Trading Commission Act of 1974 or cash in a special reserve bank account for the exclusive benefit of customers) should be classified separately in the statement of financial condition or appropriately disclosed in a note.

Memberships in Exchanges

2.27 Exchange memberships owned by a broker or dealer are generally acquired for operating purposes and should be valued at cost or at a lesser amount where there is a permanent impairment in value. Exchange memberships contributed for the use of the broker or dealer and subordinated to claims of general creditors should be carried at market value with an offsetting amount shown under liabilities subordinated to claims of general creditors. Special exchange memberships with a fixed life should be amortized over the period of expected use.

Receivable From Brokers, Dealers, and Clearing Organizations

2.28 This classification includes amounts receivable for securities failed to deliver, amounts deposited for securities borrowed, amounts receivable from clearing organizations relating to open transactions, and receivables for commodities futures accounts liquidating to a deficit on the broker's or dealer's records. If the broker or dealer clears through correspondents, there may be debit balances in the omnibus accounts of one or more of the correspondents. If the amounts are not material, they may be included in this classification. If material, such balances should be shown separately as "due from correspondent brokers."

Payable to Brokers, Dealers, and Clearing Organizations

2.29 This classification includes amounts payable for securities failed to receive, deposits received for securities loaned, and amounts payable to clearing organizations. Also included under this classification are payables for commodities futures accounts liquidating to an equity in the broker's or dealer's accounts. If the broker or dealer clears through correspondents, the credit balances in omnibus accounts of correspondents may be included under this classification, provided the amounts are not material. If material, such balances should be shown separately as "due to clearing brokers."

Receivable From and Payable to Customers

2.30 Customers, as defined in rule 15c3-1(c)(6), include all accounts resulting from normal securities and commodities transactions other than with other brokers or dealers or persons whose securities or funds either are part of the net capital of the broker or dealer or are subordinated to claims of general creditors. A broker or dealer account can be classified as a customer if the account is carried as an omnibus account in compliance with Regulation T. The accounts of officers, directors, stockholders, and employees may be included in the customer captions if they are not material. Noncustomer accounts (as defined in rule 15c3-1(c)(7)), if material, should be shown separately.

2.31 Customer commodity accounts include gains and losses on commodity futures contracts liquidating to a deficit (receivable) or equity (payable) in addition to ledger balances.

2.32 Customers' partly secured and unsecured accounts are included in this caption, and an appropriate asset valuation allowance should be established for these and other accounts if losses are probable.

Securities Purchased Under Agreements to Resell

2.33 These balances arise from "reverse repurchase agreement" security transactions that are essentially secured receivables. The receivables are carried at purchase price under an agreement to resell the securities to the seller.

Trading and Investment Accounts

2.34 *Trading Account.* Trading accounts include marketable securities, options, and spot or future commodities items that are purchased by a broker or dealer in the ordinary course of business for the purpose of maintaining them in inventory for sale to customers. A dealer in securities is a merchant who quotes, at the same time, both a price at which he will buy and a price at which he will sell. For example, dealers include specialists on the floor of securities exchanges, regular options traders on the floor of exchanges, or brokers who enter bid or ask prices in the "pink sheets" or in the National Association of Securities Dealers Automated Quotation (NASDAQ) system. For tax purposes, the profit or loss from these transactions normally will result in ordinary income or loss.

2.35 Because of the number of transactions that take place when trading for the broker or dealer or its customers, mistakes occasionally occur. These mistakes would be placed in the broker's or dealer's error account and the gain or loss recognized in income.

2.36 *Investment Account.* Investment accounts include marketable securities, options, spot, or future commodities items such as venture capital investments, oil and gas leases, and real estate investments. These investments are normally held for a long period of time and do not have a rapid turnover. For tax purposes, these types of transactions will generally result in long-term capital gain or loss. Investment accounts should be classified into two categories: marketable investments and investments with no ready market.⁴ Investments with no ready market include—

- Securities for which there is no market on a securities exchange or no independent publicly quoted market.

⁴ Generally, the term *ready market* includes a recognized, established securities market.

- Securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption, such as Regulation A, under section 3(b) of such act have been complied with).
- Securities that cannot be offered or sold because of other arrangements, restrictions or conditions applicable to the securities or to the company.

2.37 For financial statement purposes, trading and investment positions should be reported as follows:

- Marketable securities, options, and spot or future commodities items should be valued at current market value.
- Securities and other investments with no ready market should be valued at fair value as determined by the management of the broker or dealer.⁵
- The increase or decrease in unrealized appreciation or depreciation resulting from the foregoing treatments should be included as part of revenue in the income statement.
- Deferred income taxes should be provided for the difference in the reporting of these accounts for financial and tax purposes.

2.38 The current market and fair value concept recognizes that investment securities and other investments that are marketable or have no ready market appreciate or depreciate depending upon the earnings record of the companies themselves or as the market or other economic conditions dictate. Accordingly, the broker or dealer should account for its decisions to purchase, hold, or sell a particular investment during the period under review. The current market and fair value concept provides the most effective means of measuring the investment decision of the management of the broker or dealer.

2.39 The broker's or dealer's interest (assuming such interest is not merely contingent) in underwriting or joint accounts with others for issued securities should be included with the trading accounts. Where part of the joint accounts is carried by other brokers or dealers, the interest of the broker or dealer being reported on should be determined and classified as above with a contra liability to, or receivable from, the carrying broker or dealer. For joint accounts carried by the broker or dealer in which the broker or dealer has an interest, the applicable portion of the securities, options, and spot or future commodities items is normally included in the appropriate dealer or investment classifications, and the other parties' interests in the ledger balance are included in receivables or payables. Specific requirements regarding joint accounts are included in the instructions to Form X-17A-5.

2.40 Many brokers and dealers that act as principals have contractual commitments including underwriting, when-issued, when-distributed, and delayed-delivery contracts. Appropriate accrual or disclosure should be made of these commitments, and provision should be made for losses. (See chapter 5 for a discussion of government securities.)

2.41 Securities owned that are sold by the broker or dealer under repurchase agreements involving the same or substantially identical securities are treated as financing transactions, not as sales of long positions, and they are reported as securities owned, at market value, in the statement of financial condition. The amount of the repurchase agreement should be reflected as a liability.

⁵ Current practice is to carry on the equity basis investments of 50 percent or less of the voting stock of an entity that meet the criteria of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and that are made for long-term operating purposes.

Chapter 3

Internal Control Structure and Related Reporting Requirements

3.01 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, provides guidance on the auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards. SAS No. 55 describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit. The internal control structure consists of an entity's control environment, accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements of the internal control structure to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

3.02 Many of the activities of brokers and dealers are unique to the industry, and consequently many of the internal control structure policies and procedures are also unique. Such controls are concerned with receiving, delivering, pledging, borrowing, lending, transferring, and maintaining custody of securities; maintaining customers' accounts, including extending credit under the regulations of the Board of Governors of the Federal Reserve System; and transactions with other brokers, dealers, and organizations involved in clearing or settling securities transactions.

Specific Controls

3.03 Certain controls unique to brokers and dealers, such as procedures to provide reasonable assurance of compliance with SEC rules 15c3-1 and 15c3-3, are discussed in the following paragraphs. Controls that are similar to those of industrial and other commercial enterprises are not discussed. Although the following discussion deals with specific controls concerning the securities industry, it is general in nature and does not necessarily reflect the actual operations of every broker or dealer.

3.04 Internal control structure is particularly important in the following areas:

- Securities
- Customers' accounts
- Transactions with other brokers and dealers
- Suspense accounts
- Electronic data processing

Control procedures described should be performed by persons with no incompatible functions.

Securities

3.05 The objective of internal control structure policies and procedures over securities is to provide reasonable assurance that securities are safeguarded, accounting records are reliable, and related regulatory requirements are met. With respect to control over securities, the following are important internal control structure features:

- Certificate numbers should be recorded for all securities received and delivered. This is sometimes accomplished by microfilming such securities.
- Securities received should be examined for negotiability (that is, endorsement, signature, and guarantee) and for completeness (that is, coupons and warrants) before they are placed in the active box or vault.
- Securities received from customers that are registered in a name other than the customer's should be accepted only if proof of ownership is provided.
- Only specifically designated employees should be authorized to execute or guarantee assignments.
- Facsimile signature devices, if used, should be controlled.
- When securities are shipped against payment, a designated employee who does not handle securities or cash should determine that payment is received.
- Physical controls should be maintained over securities on hand. Access to areas containing securities should be restricted to authorized employees. Access to security vaults should be permitted only in the presence of two or more authorized employees.
- Customers' fully paid for and excess margin securities should be noted in the records of the broker or dealer as securities required to be in physical possession or control in accordance with SEC rule 15c3-3. If such securities are not in possession or control, adequate records should be maintained in order to determine the location of such securities and to initiate action to bring them into possession or control within the time period set forth in the rule.
- SEC rule 17a-13 requires that certain brokers and dealers must, at least once in each calendar quarter, physically examine and count all securities held and account for all other securities subject to the broker's or dealer's control or direction that are not in his physical possession. The results of such count and verification should be agreed to the securities record, with all differences noted in accordance with the rule and followed to a conclusion, where appropriate (see paragraphs 1.95 through 1.97, "Security Difference Records").
- Movements of securities should be balanced daily, and responsibility for the clearance of out-of-balance positions should be assigned to specific individuals who have no other duties related to all aspects of securities processing.
- Securities positions (and related ledger amounts) in suspense accounts should be investigated and resolved on a timely basis.

Customers' Accounts

3.06 The objective of internal control structure policies and procedures over customers' accounts is to provide control over the opening and maintaining of customers' security and commodity accounts. Brokers and dealers follow various procedures, some of which are required by regulatory authorities. These procedures include the following:

- New accounts should be approved by appropriate personnel. In addition, the account file should contain appropriate documentation

concerning the essential facts pertaining to each customer. For example, if the customer is a corporation, the file should indicate that the person from whom the orders are accepted is duly authorized by the corporation to act on its behalf. Such documentation and related account supervision procedures are referred to as the *know-your-customer rules*. Special documentation may also be required for other accounts, such as for all customers who wish to trade options or customers who are non-resident aliens.

- Margin customers should sign agreements authorizing the broker or dealer to use their securities that are not fully paid for to finance their unpaid balances by borrowing money from banks or by loaning these securities to other brokers or dealers. Such agreements are referred to as *hypothecation agreements*.
- All accounts should be in the name of the customer unless the broker or dealer has received a written statement signed by the customer attesting to his ownership of an account in any other name, symbol, or number.
- Letters should be mailed to customers requesting confirmation of changes in addresses. Some brokers and dealers mail confirmation requests to the customers' last known and current addresses.
- Statements should be mailed to customers periodically (at least quarterly) unless a customer has specifically requested, in writing, that the statement not be mailed. If there is such a waiver, it should be approved by an appropriate official.
- Procedures should be followed that ensure that the customers' statements are in agreement with the margin and security records.
- Written authorization should be required from each customer for whom the broker or dealer carries a discretionary account. Every trade in the discretionary account should be approved by appropriate personnel. The person delegated the responsibility to approve should not also exercise discretionary authority. An advice should be mailed to the discretionary account customer on the date each trade is executed.
- Separate identification should be maintained for the accounts of all partners, officers, employees, and their known relatives so that transactions in such accounts can be reviewed by appropriate personnel.
- Written approval for opening an account should be obtained from the employer of an employee of another broker or dealer.
- Funds should not be paid nor securities withdrawn from customers' accounts without the proper authorization of appropriate margin department personnel.
- Margin records should be reviewed periodically by an employee who has no duties in connection with them to determine that the minimum margin requirements of the firm are being maintained.
- The margin department of a broker or dealer should have a system to prevent violations of Regulation T and similar regulations dealing with the extension and maintenance of credit. Procedures should be followed that ensure that all necessary margin calls are made and followed up.

- Duties should be delegated appropriately and personnel in key control areas should be rotated.

Transactions With Other Brokers and Dealers

3.07 The following factors should be considered with respect to transactions with other brokers and dealers:

- The details of fails-to-receive, fails-to-deliver, securities loaned, and securities borrowed should be agreed periodically to the securities record in accordance with SEC rule 17a-13. In addition, the respective amounts receivable or payable should be agreed to the related general ledger control accounts.
- Aging schedules of fail-to-receive and fail-to-deliver transactions should be maintained currently.
- For accounts carried by other brokers, such as omnibus accounts, the details of transactions should be agreed daily and reconciled at least monthly, and there should be appropriate responsibility for resolving any differences.

Suspense Accounts

3.08 There should be periodic, preferably daily, review, aging, and reporting to appropriate officials of open P&S suspense items, since suspended trades represent potential “fails,” “DK’s,” unknown inventory positions or financing costs. There should also be periodic review of operations suspense items to determine the propriety of receivables or payables carried in the account. Specific control procedures also include comparison of suspense items with underlying trade tickets or other records, and reviews of the propriety of the subsequent clearance of suspense items.

Electronic Data Processing

3.09 The basic concepts of the internal control structure apply equally to manual, mechanical, and EDP systems. However, the method of data processing used may influence the organization and procedures required to accomplish those objectives of the internal control structure. It may also influence the procedures employed by an auditor in his consideration of the internal control structure to determine the nature, timing, and extent of audit procedures to be applied in his audit of financial statements.

Internal Audit Function

3.10 Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity’s Internal Control Structure Over Financial Reporting*, paragraph 23, states—

... An important responsibility of the internal audit function is to monitor the performance of an entity’s controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific internal control structure policies and procedures. The results of these tests are often an important basis for management’s assertions about the effectiveness of the entity’s internal control structure. A practitioner should consider the guidance in SAS No. 65, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*, when assessing the competence and objectivity of internal auditors, the extent of work to be performed, and other matters.

The internal audit division of the Securities Industry Association has issued guidelines for establishing and maintaining a professional, effective, and independent internal audit function in a securities industry firm.

Reporting on the Internal Control Structure by Independent Auditors

SEC Rules

3.11 SEC rule 17a-5(g) gives the SEC's discussion of the objectives of an examination by independent auditors, which include obtaining a reasonable assurance that material inadequacies existing at the date of the examination in the accounting system, internal accounting controls, and procedures for safeguarding securities would be disclosed. Rule 17a-5(g)(1) also lists the following as a specific objective:

A review of the practices and procedures followed by the broker or dealer in

- (i) making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e);
- (ii) making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by rule 17a-13;
- (iii) complying with the requirement for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System; and
- (iv) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

These objectives recognize the regulatory concern for safeguarding customers' property held by brokers and dealers.

3.12 The SEC requires independent auditors to issue a report on the internal control structure. To meet this requirement a report should (1) express an opinion on the adequacy of the practices and procedures listed above in relation to the definition of a material inadequacy as stated in rule 17a-5(g)(3) and (2) disclose material weaknesses in the internal control structure (including procedures for safeguarding securities) that are revealed through the auditor's consideration of the internal control structure to determine the scope of auditing procedures. SAS No. 30* gives guidance in paragraphs 54 through 59 on reports based on criteria established by regulatory agencies and states that an agency may publish specific criteria for evaluating the adequacy of internal accounting control for its purposes. Rule 17a-5(g)(3) states—

A material inadequacy expected to be reported includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to

- (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers, dealers or creditors;
- (ii) result in material financial loss;
- (iii) result in material misstatements of the broker's or dealer's financial statements; or

* Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, supersedes SAS No. 30, but does not cover reports provided pursuant to Rule 17a-5 and in Form N-SAR.

- (iv) result in violations of the [SEC's] record-keeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in parts (i), (ii) or (iii) of this subparagraph (3).

SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, provides guidance on identifying and reporting conditions that relate to an entity's internal control structure observed during an audit of financial statements. SAS No. 60 defines a material weakness in the internal control structure as a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. As used below, the term *material inadequacy* encompasses either a material weakness in the internal control structure or a material inadequacy in the practices and procedures in SEC rule 17a-5(g)(1) or regulation 1.16d(1) of the Commodity Futures Trading Commission (CFTC) as appropriate (see later sections of this chapter for further discussion of CFTC requirements).

3.13 In compliance with the SEC rules, the auditor is required to review and conduct appropriate tests of the accounting system, control procedures, and procedures for safeguarding securities for the period since the prior audit date. If, based on the review and tests of such controls, no material inadequacies are found to exist with respect to any of those matters, the auditor should state this in his report on the internal control structure. However, if during the performance of year-end work or interim work, material inadequacies are found to exist, the report should disclose the nature of the inadequacies and the corrective action proposed to be taken or already taken by the broker or dealer. The auditor should follow the guidance in SAS No. 30,* paragraph 42, which states "if management has implemented control procedures to correct the weakness, the accountant should not refer to this corrective action (in his report) unless he has satisfied himself that the procedures are suitably designed (to correct the weakness) and are being applied as prescribed."

3.14 The auditor's responsibility with respect to material inadequacies as described in rule 17a-5(h)(2) is as follows:

If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the [SEC] and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d) and (f) of Rule 17a-11. The broker or dealer shall also furnish the accountant with a copy of said notice to the [SEC] by telegraphic communication within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if he disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the [SEC] and the designated examining authority by report of material inadequacy within 24 hours thereafter as set

* Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, supersedes SAS No. 30, but does not cover reports provided pursuant to Rule 17a-5 and in Form N-SAR.

forth in Rule 17a-11. Such report from the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.

3.15 A determination of a material inadequacy may, in many instances, require particular audit procedures in the affected area, appropriate review at the decision-making level by management and the independent auditor, and possible consultation with counsel. The length and complexity of any necessary deliberations will depend on the circumstances, but the contemplative process should be completed in the shortest time possible.

3.16 The report shown in exhibit I in Appendix A of this guide is appropriate when the auditor has completed his audit of the financial statements. If the auditor becomes aware of a material inadequacy that was corrected during the period but not reported by management to the SEC and the broker's or dealer's designated examining authority, management's failure to report the condition would constitute a material inadequacy that should be included in the auditor's report. Pursuant to SEC rule 17a-5(d), the report should be filed along with the annual audit report. Rule 17a-5(c)(2)(iii) provides that when the independent auditor has commented on a material inadequacy, the broker or dealer must include in the statement of financial condition furnished to customers a statement that a copy of such report is currently available at the principal office of the SEC in Washington, D.C., and at the regional office of the SEC for the region in which the broker or dealer has its principal place of business. The report shown as exhibit J in Appendix A of this guide should be used if an audit has not been completed and if the independent auditor disagrees with the notification made by the broker or dealer, or if the broker or dealer has failed to make the required notification. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.

CFTC Rules

3.17 Regulation 1.16(c)(5) of the CFTC also requires a report describing any material inadequacies found to exist or to have existed since the date of the previous audit. If the audit did not disclose any material inadequacies, the report should so state.

3.18 Regulation 1.16(d)(1) specifies that the audit should include reviews of (1) the practices and procedures followed in making the periodic computation of the minimum financial requirements pursuant to regulation 1.17, (2) the daily computations of segregation requirements according to section 4(d)(2) of the Commodity Exchange Act (the Act) and the regulations thereunder, and (3) the segregation of funds based upon such computations.

3.19 Regulation 1.16(d)(2) defines a material inadequacy in much the same way as does rule 17a-5(g)(3). However, it changes the fourth condition of inadequacy, as quoted in paragraph 3.12, to any condition that could reasonably be expected to result in violations of the CFTC's segregation, record-keeping, or financial reporting requirements to the extent that the broker's or dealer's ability to promptly complete transactions or discharge its responsibilities to customers or other creditors would be inhibited, or to the extent that a material misstatement of the broker's or dealer's financial statements and schedules could result.

3.20 If the auditor discovers a material inadequacy during either his preliminary or final work, he should call the inadequacy to the attention of the broker or dealer, who should then inform the CFTC by telegraphic notice

within three business days. A written report is to be sent to the CFTC within five business days, stating what steps have been and are being taken to correct the material inadequacies. The broker or dealer also should furnish the auditor with a copy of the telegraphic notice within three business days. If the auditor does not receive a copy of the notice or if he disagrees with the statements in it, he is required to inform the CFTC and the self-regulatory organization within the three business days.

3.21 The auditor should be aware that whereas the audit objectives in CFTC rule 1.16(d) relate to the discovery of material inadequacies existing at the date of the examination, the requirements of regulation 1.16(c)(5) relate to the reporting of material inadequacies "found to exist or found to have existed since the date of the previous audit." Thus, although the auditor is not required to search for material inadequacies that existed during the period but were corrected prior to the end of the period, he should include any such condition he becomes aware of in his report on internal accounting control. The auditor's report need not include material inadequacies the auditor became aware of that management has reported to the CFTC and corrected prior to the end of the period. Exhibit K in Appendix A of this guide shows the report to be used by the independent auditor when filing his report with the CFTC.

Chapter 4

Auditing Considerations

Prescribed Audit Objectives

4.01 SEC rule 17a-5 discusses the objectives of the annual audit of the financial statements of a broker or dealer as follows:

(1) The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, changes in financial position, and the Computation of Net Capital Under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers Under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3. The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities and (d) the practices and procedures whose review is specified (see the section of chapter 3 dealing with reporting on internal accounting control for a list of the procedures) would be disclosed.

(2) If the broker or dealer is exempt from Rule 15c3-3, the independent public accountant shall ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to his attention to indicate that the exemption had not been complied with during the period since his last examination.

Auditing Procedures

Extent and Timing of Auditing Procedures

4.02 With respect to the extent and timing of auditing procedures, rule 17a-5 also states, in part—

The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (g) above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

4.03 Certain auditing procedures may be performed at a date other than the date of the financial statements, including work pertaining to security counts and related confirmations. SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Substantive Tests Prior to the Balance Sheet Date," gives guidance on factors to be considered before applying substantive tests to details of assets and liability accounts at a date prior to the date of the financial statements.

4.04 In determining the extent of procedures to be performed, the auditor should consider the materiality of the item in question and the possible effect of a misstatement in the financial statements and related schedules. Additionally, the audit scope for review and testing of procedures relative to net capital, quarterly security counts, and compliance with Regulation T and rule 15c3-3 should be sufficient to provide reasonable, but not absolute, assurance that any material inadequacies existing at the audit date would be disclosed as prescribed in rule 17a-5. (See chapter 3 for the SEC's definition of a material inadequacy.)

Nature of Auditing Procedures

4.05 Certain auditing procedures unique to an audit of a broker or dealer are discussed in the following paragraphs. Auditing procedures that are similar to those for audits of industrial and other commercial enterprises are not described in this guide. Nothing in the following discussion should be construed as limiting the independent audit or prohibiting the omission of any procedures he deems unnecessary in the circumstances.

Planning Considerations

4.06 Before starting the engagement, the independent auditor should refer to the guidance provided by SAS No. 22, *Planning and Supervision*. At the start of the audit, to avoid confusion and to ensure the minimum amount of inconvenience to the client, it is desirable for the auditor to meet with the client's operating personnel to discuss the audit. Before undertaking the audit, the auditor may wish to make a study of the physical layout of the client's principal office, the organization of the employees' duties, and other similar factors.

Review of In-House Data Processing Operations

4.07 If the client uses in-house EDP systems, the independent auditor should consider the internal control structure over such systems. Situations involving the more complex EDP applications ordinarily will require that the independent auditor apply specialized expertise in EDP when performing the necessary auditing procedures.

Review of Controls at EDP Service Centers

4.08 The use of an EDP service center may improve internal control because of the separation of responsibilities inherent in the third-party status of the service organization. However, it in no way diminishes the requirements for the auditor to review the input/output controls in effect at the broker or dealer.

4.09 The auditor should identify significant classes of transactions that are processed by the service center and obtain an understanding of the flow of transactions through the entire accounting system, including the portion maintained by the service center. The facts and circumstances of each case will determine the additional work that needs to be done by the auditor with regard to controls at the service center. If, for example, after examining the output of the service center, the auditor is satisfied that the broker or dealer is able to check the daily output throughout the year, he may not need to review the service center's processing controls any further. However, the auditor should inquire about problems pertaining to system continuity or data file security due to inadequate equipment or program backup or poor control at the service center.

4.10 SAS No. 55 states that an auditor should obtain a sufficient understanding of each of the three elements of an entity's internal control structure to plan the audit. If the broker or dealer uses an EDP service center or other service organization, certain policies, procedures, and records of the service center may be relevant to the broker or dealer's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the broker or dealer's financial statements. A service auditor's report on policies and procedures placed in operation at the service organization should be helpful in providing a sufficient understanding to plan the audit of the broker or dealer. Such a report, however, is not intended to provide any evidence of operating effectiveness of the relevant policies and procedures that would allow the auditor of the broker or dealer to reduce the assessed level of control risk below the maximum. Such evidence should be derived from one or more of the following:

- a. Tests of the broker or dealer's control over the activities of the EDP service center.
- b. A service auditor's report on policies and procedures placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.
- c. Appropriate tests of controls performed by the auditor of the broker or dealer at the EDP service center.

SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, provides further guidance on the factors that an auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

Tests of Stock Record Positions

4.11 The independent auditor's objectives in testing stock record positions are to determine that positions on the stock record, including securities, debt instruments, and options, are balanced and to determine which positions should be subjected to auditing procedures, where appropriate. Audit evidence for stock record positions may be obtained by physical inspection or through confirmation or a combination of both.

Securities in Physical Possession

4.12 The independent auditor would normally account for securities in physical possession by counting, or as part of the quarterly security count requirements of SEC rule 17a-13, by observing and testing the broker's or dealer's procedures for physical inspection.

4.13 If the auditor observes the broker's or dealer's security count, he should consider whether procedures employed result in a complete and accurate count. He should review the procedures used; review the execution of these procedures; and, to the extent necessary, perform test counts and appropriate follow-up procedures.

4.14 If the auditor tests securities on hand at interim dates, he may want to be involved in the quarterly count made on the date closest to the date of the financial statements. This involvement could be limited to discussions with the broker or dealer and to a review of the procedures to be followed during the count to determine if they are consistent with those that the independent auditor has previously reviewed, tested, and determined to be reasonable. Depending on the significance of the security count (for example, considering volume of securities on hand or involvement of internal auditors), the auditor

may want to be present during portions of the count to satisfy himself that those procedures are being followed and that there has been no change from the procedures tested. The auditor should be familiar with the guidance provided by SAS No. 45 and SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

4.15 The independent auditor should inquire about the results of the security count and determine whether there are any material unresolved differences. If there are such differences the auditor should satisfy himself to the extent he considers necessary concerning the reason, nature, and ultimate disposition of the differences and their impact on the financial statements and other regulatory reporting requirements.

Securities in for Transfer, Exchange, or Redemption

4.16 A broker or dealer, particularly one that engages in a substantial volume of transactions, may have a separate transfer department or division to handle securities held for transfer. The securities handling procedures are substantially the same for all brokers and dealers and do not vary materially with the size or plan of organization. Securities in for transfer, exchange, or redemption include—

- Securities on hand pending preparation of instructions for transfer of title, exchange, or redemption.
- Securities on hand awaiting processing for delivery or routing to securities boxes.
- Securities on hand that are not in negotiable form because legal documents (such as those necessary to qualify one to act as executor, administrator, or guardian) are not available. These securities are frequently referred to as legal securities.
- Securities delivered to local transfer agents for transfer of title, exchange, or redemption and for which window tickets or receipts are held.
- Securities sent to out-of-town transfer agents or to corporate issuers for transfer of title, exchange, or redemption. Copies of transmittal correspondence or multicopy transfer instructions should be available for inspection.
- Securities receivable from other brokers or dealers that have initiated transfer-of-title procedures. This situation occurs when a broker receives one or more certificates for more shares than required and thus has the excess shares transferred to the name of the delivering broker or dealer.
- Securities in the process of being transferred through DTC or any other depository services.

4.17 The first three of the above types of securities (that is, securities on hand) should be subjected to auditing procedures similar to those for other securities in physical possession. The last four of the above types of securities may be audited, to the extent the auditor deems necessary, by direct correspondence with the transfer agents, the corporate issuers, or the other brokers or dealers, or by physical examination of the securities when they are returned to the broker or dealer. In determining the procedures to be applied, the auditor should consider the length of time such items have been in transfer. Examination of the securities when they are returned implies that it is reasonable to assume that such returns suggest that the securities were held by the transfer agent on the date of the financial statements being audited.

Securities Held at Depositories

4.18 Brokers and dealers generally assign one individual or department the responsibility for balancing the positions with depositories and clearing organizations. The independent auditor should consider obtaining directly from these organizations copies of a statement of security positions of the broker or dealer as of the date of the security count. The broker or dealer should prepare a reconciliation of positions held by these organizations, which the auditor should test by comparing it to his copy of the statement. For the continuous net settlement accounts, there is a direct relationship between the net market value of the securities to be settled and the money to be settled. This relationship should be reviewed and any differences explained. Since most of the securities maintained by many brokers and dealers will be located at one of these organizations, the independent auditor needs to consider the internal control structure in effect at such organizations. He may do so by obtaining the most recent report on policies and procedures placed in operation (and tests of operating effectiveness) issued by that organization's independent auditors. (See SAS No. 70.)

Securities Failed-to-Receive and Failed-to-Deliver, Securities Borrowed and Loaned, and Securities Held as Collateral for Bank Loans

4.19 The independent auditor would normally test the positions of securities failed-to-receive, failed-to-deliver, borrowed and loaned, and held as bank loan collateral through confirmation with the other party to the transaction. The extent of the confirmation procedures should be based on the auditor's judgment concerning the internal control structure, size of accounts, relationship of money balance to security value, and types of errors or irregularities that have occurred.

Securities Held by Branch Offices

4.20 The auditor should inquire about securities held by branch offices and, if material, should consider whether he should inspect them in coordination with the inspection at the main office. Otherwise, he should determine whether a review of the broker's or dealer's procedures for controlling and accounting for securities at branch offices would be sufficient.

Securities Position Differences

4.21 All differences disclosed through the comparison of counts and confirmations with the records of the broker or dealer should be resolved by the broker or dealer, and any adjustments should be reviewed by the auditor as he considers necessary.

Tests of General Ledger Accounts and Balances

4.22 The independent auditor's tests of general ledger accounts and balances includes, but is not limited to, tests of the following:

- Customers' accounts
- Trading and investment accounts
- Good-faith deposits
- Capital accounts
- Subordinated accounts and borrowings
- Dividends receivable or payable
- Unclaimed dividends, coupons, and securities

- Exchange memberships
- Income, expenses, and other credits and charges
- Open contractual commitments

Customers' Accounts

4.23 The independent auditor normally should confirm account positions and balances, either through positive or negative requests or a combination of both. The type and extent of confirmations used should be based on the auditor's judgment in the particular circumstances. SAS No. 67, *The Confir-*

mation Process, provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. Sampling techniques may be appropriate if there are many accounts. In selecting customers' accounts for confirmation, the auditor needs to consider the security positions in such accounts as well as the ledger (money) balances; he also should consider confirming some accounts with zero balances.

4.24 When the auditor sets out to confirm customers' accounts through positive requests, he should generally follow up with second requests to those accounts not replying. The auditor should consider employing such alternative procedures that are practical under the circumstances if no reply is received. For guidance, the auditor should refer to SAS No. 67.

4.25 A client might, for his own purposes, request that the auditor extend the confirmation of customers' accounts beyond those necessary for purposes of the audit. In those cases, the auditor should consider the implications on his auditing procedures of errors discovered in performing the additional confirmations at the request of the client.

4.26 The auditor should also review the customers' accounts for evidence of undermargined, partly secured, or unsecured conditions that may affect the net capital computation under SEC rule 15c3-1 and the reserve and possession or control requirements of rule 15c3-3, as well as the collectibility of accounts. In performing such a review, it may be helpful to obtain an *equity run*, which is a report that indicates for each customer account the ledger balance and the market values of all securities positions in the customer account.

4.27 In performing his work in the customer area, the auditor should review the broker's or dealer's practices and procedures that are established to comply with Regulation T and SEC rules 15c3-1 and 15c3-3.

Trading and Investment Accounts

4.28 The independent auditor should ascertain that the trading department position records are in agreement with or have been reconciled to the stock record and that accruals for the broker's or dealer's inventory positions related to unsettled trades are made (see paragraph 2.10, "Settlement Data Versus Trade Date Basis Financial Statements," for further details). In addition, he should test the values of such securities. Securities traded are valued at market, which is either the closing price for listed securities on the date of the financial statements or—in the event that no transactions occurred on that date—at the appropriate closing bid or asked prices, in accordance with the company's established procedures.

4.29 Market prices for securities regularly traded are obtained from financial journals or other sources. All the sources should be clearly indicated in the working papers. Quotations may not be available for exempted securities and securities not actively traded. In such cases the auditor may obtain prices for the securities from the trading department of the broker or dealer being examined; however, he should test material items independently with other brokers or dealers that have knowledge of the particular security or with other appropriate sources. The sources of market price quotations used should be documented.

4.30 Market quotations may not be available for all securities. In such cases fair value would ordinarily be determined by management. The independent auditor does not function as an appraiser and is not expected to substitute his judgment for that of the management of the broker or dealer; rather, he should review the information considered by management and determine whether the procedures followed are reasonable in the circumstances. The

valuation of municipal bonds is of particular importance to the auditor. In most cases market quotations are not available for bonds issued by political subdivisions, and the auditor needs to evaluate the methods and bases underlying the valuation of such bonds. The pricing of municipal bonds is not an exact science and varies depending on the financial and other information about the political subdivision and the specific bond in question. Factors such as the rating on the bond, the coupon rate, the prime lending rate, any redemption provisions, the maturity date, and so forth, are all important in determining the value of the municipal bond.

4.31 Municipal bonds for which market quotations are not readily available or for which market quotations are unreliable should be valued at fair value as determined by management. For those determinations, management may authorize the use of *matrix pricing* or pricing based on reliable quotations of similar securities. The mathematical technique known as matrix pricing is used to determine security values based on market data available with respect to the issue and similar issues without exclusive reliance on quoted market prices. If management or its pricing service uses matrix pricing, the auditor's understanding of the procedures should be sufficient to satisfy him that the procedures produce a reasonable determination of fair value. He should perform those test calculations he deems necessary in the circumstances. As partial substantiation for the valuation of municipal bonds, the auditor may also wish to review purchases or sales made shortly before and after the valuation date being tested. He may also request a valuation from other brokers or dealers or independent pricing services.

4.32 Management's fair valuation procedures of municipal bonds or securities that are not readily marketable are designed to approximate the values that would have been established by market forces. These procedures are generally a good faith estimate by management to determine the value of nonmarketable securities. Although the auditor may determine that the underlying documentation supports the fair value estimates, he may conclude that because the range of possible values is significant, he must issue a qualified opinion. The qualification should relate to an adjustment that might have been required if a ready market value existed. (See the notes to exhibit A in Appendix A of this guide.)

4.33 If the auditor concludes that the procedures used to estimate value are reasonable, the documentation is appropriate, and the range of possible values is not significant, he need not modify his opinion.

Good-Faith Deposits

4.34 Normally, good-faith deposits accompany bids to purchase new issues of securities. The deposit and the related commitment normally can be confirmed at the same time. The broker or dealer may be acting as the manager of a group making a bid for a new issue of securities; in such cases the other participating members usually deposit proportionate amounts of the required deposit with the managing dealer. The auditor may request that the participants confirm the amount of their deposit in writing.

Capital Accounts

4.35 For an incorporated broker or dealer, the auditor's procedures related to capital accounts normally are the same as those for other commercial corporate clients and are not discussed in this guide. For a partnership, the auditor should examine the partnership agreement. In addition, he should determine the extent to which securities or equities in the partners' security or

commodity accounts may be included in partnership equity or in net capital or the extent to which they are otherwise available to the creditors of the firm.

Subordinated Accounts and Borrowings

4.36 The independent auditor should obtain satisfaction concerning subordination or secured demand note agreements and determine whether they have been approved by the appropriate regulatory bodies. This may be done through direct confirmation. Additionally, he should determine through confirmation the expiration dates of the agreements, the extent of the amount subordinated, any limits in relation to those amounts, and the exact nature of the liability to the subordinating party. This information is needed to determine the carrying value of these accounts and the appropriate treatment under net capital rules.

Dividends Receivable or Payable

4.37 Dividends receivable in cash or securities should be analyzed and reviewed for age and collectibility, and those that are material in amount should be confirmed, if deemed appropriate. Most brokers and dealers do not record dividends receivable or payable on "long" or "short" stock positions on the record date. The recording is not made until the payable date of the dividend, which can be a few days or several weeks after the record date. This practice may result in understatements of assets and income (long positions) or liabilities and expense (short positions) when a dividend record date and payable date straddle the date of the financial statements. The auditor should review the procedures for recording dividends receivable and payable and consider whether any unrecorded amounts are material.

Unclaimed Dividends, Coupons, and Securities

4.38 The auditor should review the procedures followed by the broker or dealer for recording material transactions in accounts for unclaimed dividends, coupons, and securities. Detailed accounts maintained for unclaimed items should be compared with control accounts. Charges against unclaimed items can be examined on a selected basis and compared to claims or correspondence, particularly charges against older items. The auditor should review the broker's or dealer's procedures for determining its compliance with state laws. Market action affecting underlying items may give rise to contingent liabilities and net capital charges, and such activity should be reviewed.

Exchange Memberships

4.39 The ownership of exchange memberships can be confirmed through direct correspondence with the exchange. An exchange membership is normally registered in the name of an individual; however, it is ordinarily an asset of the broker or dealer if it is held by the broker or dealer under an A-B-C agreement or if its use has been contributed to the broker or dealer under a subordination agreement.

4.40 Under an A-B-C agreement, the member agrees that the member or his legal representatives will comply with one of the following options if the member organization is dissolved, if the member ceases to be a participant in the organization, if the member dies, or if other contingencies occur.

- Retain the membership and pay to the broker or dealer the amount necessary to purchase another membership.
- Sell the membership and pay the proceeds over to the broker or dealer.

- Transfer the membership for nominal consideration to a person who is designated by the broker or dealer and is satisfactory to the exchange.

4.41 It is not unusual for a broker or dealer to have more than one membership on a particular exchange. The propriety of considering exchange memberships as assets of the broker or dealer should be evaluated by referring to partnership agreements or other documents of the broker or dealer. Also, the auditor should satisfy himself concerning the propriety of the carrying value of the memberships and whether the carrying value has been permanently impaired.

Income, Expenses, and Other Credits and Charges

4.42 As in other industries, the procedures followed in examining income and expense accounts will depend on the materiality of the items and the internal control structure. The auditor should consider such matters as stock exchange volume, the broker's or dealer's share of the market, changed conditions (such as volume of new securities offerings), changes in character of the broker's or dealer's business, and the trend of securities prices. A discussion of this comparative data with the management of the broker or dealer may highlight areas that require additional auditing procedures.

4.43 The auditing procedures for the substantiation of many of the income and expense items such as interest, dividends, employee compensation, occupancy, communications, promotion, and taxes are similar to those for other industries and thus are not discussed in this guide. The auditor should test a sample of trading and investment profit and loss transactions and test whether trading and investment inventories are valued at market. Any market adjustments should be reflected in current earnings. Calculations of commission income should be tested and may be analyzed in relation to trading volumes or to compensation of registered representatives. Provisions for uncollectible accounts and for potential loss on aged fails, aged transfers, aged dividends receivable, and security shortages should be analyzed and reflected in the proper accounting period. Accounts reflecting gains or losses from closed-out security differences should be reviewed, and consideration should be given to the effect of possible claims arising from closed-out "long" differences (overages). Accruals should be tested to determine that they are made in the appropriate accounting period for such items as investment advisory fees, amounts due to and from syndicate account managers and professional fees. The auditor should determine that accruals have been properly made for commission income and trading profits and losses resulting from unsettled transactions.

Open Contractual Commitments

4.44 Contractual commitments that are normally not recorded in liability accounts include underwriting commitments, when-issued contracts, endorsements of puts and calls, and commitments in foreign currencies.

4.45 The independent auditor may wish to confirm on a test basis those contractual commitments, other than endorsed puts and calls (the holders of which are unknown). In many cases the commitments of customers will appear in the accounts of the customers and will be confirmed at the time the accounts are confirmed. In other cases, however, information concerning purchases and sales of securities on a when-issued or when-distributed basis may not appear in the accounts of customers or in the stock record but instead may be maintained in a subsidiary record (for example, tickets in an open contract file). In such cases the open contracts may be confirmed in the same

manner as other accounts. In some instances when a settlement date (subsequent to the date of the financial statements) has been fixed for an open contract transaction, the broker or dealer will clear the open contract file and enter the transactions on the settlement blotter for the day of settlement. These are not regular-way transactions and may be confirmed separately; if material, they should be disclosed in a commitments or contingencies note to the financial statements.

4.46 Another type of contract involves the broker's or dealer's interest in joint accounts in issued or "to be issued" securities carried by other brokers or dealers. In many cases the interest in these security positions is not recorded in the general ledger of the non-carrying member of the joint account. In these cases an adjustment is usually recorded in the trial balance to reflect such accounts in the financial statements. Details of the joint accounts may be confirmed in writing with the carrying brokers to the extent the auditor considers necessary.

Auditing Omnibus and Fully Disclosed Accounts

Tests of Omnibus Accounts

4.47 *Clearing Brokers.* A broker or dealer may perform clearing functions for other brokers (the initiating brokers), and an auditor may confirm those brokers' balances in omnibus accounts. The broker or dealer should explain any differences that exist between the books and confirmation responses, and reconciling items should be traced to supporting documentation. The auditor should test the clearing broker's segregation, transfer, and cashiering operations and controls pertaining to transactions of the initiating broker to determine that the instructions of the initiating broker were carried out on a timely basis, in compliance with their agreement, and in accordance with the prescribed rules and regulations of applicable regulatory agencies. In addition, the auditor may want to trace selected trades in the omnibus accounts to underlying documentation furnished by the initiating broker and perform tests to determine that the clearing fee was determined in conformity with the applicable agreement.

4.48 *Initiating Brokers.* The balance in the omnibus account should be confirmed with the clearing broker. The auditor should trace any difference between the confirmation response and the client's records to underlying documentation. In addition, the auditor should consider testing the computation of the clearing fee for compliance with the related agreement.

Tests of Fully Disclosed Accounts

4.49 *Carrying Brokers.* Since the accounts of the introducing broker's customers are maintained on the books of the carrying broker, as if they were customers of the carrying broker, the auditing procedures applicable to these accounts are the same as those performed on other customers' accounts. In addition, the auditor should consider testing the fees earned for carrying the other broker's accounts.

4.50 *Introducing Brokers.* The auditor should determine that the introducing broker is credited with the appropriate fee for trades generated by its customers. There should be tests of the introducing broker's system to verify that all trades were executed in accordance with its instructions and that fees were determined in compliance with the applicable agreement. Such tests would ordinarily include comparing daily trading activity summaries prepared by the carrying broker with memorandums of the introducing broker.

Internal Accounting Controls Over Omnibus and Fully Disclosed Accounts

4.51 When auditing the omnibus account of an initiating broker or the fully disclosed accounts of an introducing broker, the auditor should consider the relationship with, and financial viability of, the clearing or carrying broker, respectively, and should consider obtaining from management the report on internal accounting control filed by the clearing or carrying broker with the SEC. Also, he should consider whether, under the guidelines of SAS No. 70, it would be appropriate to request a service auditor's report on policies and procedures placed in operation (and tests of operating effectiveness) from the clearing or carrying broker.

Auditing Other Transactions

Private Placements

4.52 The audit of private placement transactions may include a review with management of agreements between the broker or dealer and entities for which debt or equity securities have been placed. The auditor should review the status of the individual contracts to determine any existing obligations of the broker or dealer that may require disclosure in the financial statements. In addition, the auditor should consider confirming outstanding contractual agreements offsetting customers' commitments to purchase such securities.

Mutual Funds

4.53 Procedures for testing mutual fund transactions will differ depending on the amount of activity and the method of accounting for customer purchases and redemptions. Few auditing procedures are necessary in cases in which the broker assists a customer in the purchase or redemption of mutual fund shares in the name of the customer. However, when a broker or dealer, acting in a custodial capacity for customers, maintains an active account in its name with one or more mutual funds, certain procedures should be considered. The procedures may include confirming the number of shares held by the mutual funds in the name of the broker and comparing these quantities to safekeeping records of the broker or dealer. Depending on the materiality of open purchases or redemptions, these amounts may also be confirmed.

Refunding Bond Underwritings

4.54 The independent auditor's concern in examining bond underwritings should not vary from those concerns surrounding regular underwritings and open contractual commitments. However, he should exercise care in determining whether the broker or dealer has met its commitment to the political subdivision to purchase the U.S. government securities that are to be placed in escrow. Often the U.S. government securities may not be available in the quantities desired or at the same price as anticipated at the time the underwriting agreement was executed. In such cases the broker or dealer may sustain losses in satisfying its obligation to the political subdivision.

Suspense Accounts

4.55 The purchase and sales and the operations suspense accounts should be analyzed at the end of the period and amounts reclassified to the appropriate inventory, customer, receivable, payable or other accounts for financial reporting purposes. The auditor should review the analysis for propriety of

aging and classification. He might also test specific items by confirmation with third parties, comparison with underlying records or other appropriate procedures.

Computation of Formula for Determination of Reserve Requirement

4.56 Among other things, SEC rule 15c3-3(e) provides that—

Every broker or dealer shall maintain with a bank or banks at all times when deposits are required or hereinafter specified a “Special Reserve Bank Account for the Exclusive Benefit of Customers” (hereinafter referred to as the “Reserve Bank Account”), and it shall be separate from any other bank account of the broker or dealer. Such broker or dealer shall at all times maintain in such Reserve Bank Account, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached hereto as Exhibit A.

4.57 Exhibit A of rule 15c3-3 provides a detailed formula for determining the reserve bank account requirement. In addition, the designated times for the computations are outlined in the rule.

4.58 The rule also requires a broker or dealer to promptly obtain physical possession or control of all fully paid securities and excess margin securities carried for the account of customers, and it requires the broker or dealer to act within a specified time period when possession or control has not been established.

4.59 The auditor should review the broker’s or dealer’s procedures and controls covered by this rule and should perform those tests he considers necessary to satisfy himself that the procedures and controls, including the written documentation, provide reasonable assurance that the broker or dealer is in compliance with the rule.

Report to Be Rendered on SIPC Annual Assessment

4.60 The Securities Investor Protection Corporation (SIPC) makes assessments on its members from time to time, depending on the needs of its fund. As of May 1, 1983, SIPC members are required to pay an assessment of one-quarter percent of gross revenues, as defined, and to file a report on the SIPC assessment. Procedures that are applicable for reporting on the SIPC annual assessment are given in SEC rule 17a-5(e)(4). Exhibit L in Appendix A of this guide illustrates the independent auditor’s report on the annual assessment. The auditor should determine the requirement for a separate report at the time of his audit. (See the discussion of the contents of the FOCUS report in chapter 2.)

Filing Reports

4.61 Rule 17a-5 gives the filing requirements for the annual audited reports. The reports are to be filed with the SEC in Washington, D.C., and the appropriate regional office and with the broker’s or dealer’s designated examining authority. Upon request, confidential treatment is given for portions of the report.

4.62 If a broker or dealer finds that it cannot file its report for any year within the specified period without undue hardship, it may file an application with the appropriate regional office of the SEC before the due date of the report and request an extension of time. Notice of such application should also be sent to the designated examining authority. The application should state the reasons for the extension, describe the circumstances that are beyond the

control of the broker or dealer, and indicate whether there are financial or record-keeping problems or if there are violations of net capital or the requirements of rule 15c3-3. The request should be accompanied by a letter from the independent auditor stating—

- The reasons for the extension request.
- Whether there is any indication of material inadequacies in the accounting system, internal control structure, or procedures for safeguarding securities.
- Whether there is any indication that the condition of the broker's or dealer's records is endangering its ability to supervise its registered representatives and their handling of customers' accounts.
- Whether there is any indication that the broker or dealer is in violation of the net capital requirements specified in rule 15c3-1 or the requirements of rule 15c3-3 or has any significant financial or record-keeping problem.

See footnote 2 in chapter 2 for further discussion.

Brokers and Dealers Exempt From SEC Rule 15c3-3

4.63 Certain brokers and dealers adhere to the exemptive provisions of rule 15c3-3. In doing so, the broker or dealer is not required to comply with the remaining provisions of that rule, such as computations of amounts required to be on deposit in a “special reserve bank account for the exclusive benefits of its customers,” possession and control requirements, and so forth. The detail requirements to be met in order to qualify for such exemption are outlined in rule 15c3-3 and need to be considered in connection with the rule in its entirety. Therefore, it is impractical to describe all such conditions; simply stated, however, to qualify for exemption the broker or dealer may not put at risk any customer's funds or securities.

4.64 In auditing the financial statements of a broker or dealer that is claiming exemption from rule 15c3-3, the auditor should determine under which specific section of the rule the exemption is being claimed and what controls and procedures are in place to ensure compliance with that section. He should then design tests to provide reasonable assurance of compliance during the year and at year-end. In the event compliance has not been met or the controls and procedures are deemed inadequate, the auditor should immediately consider the notification requirements under rules 17a-5 and 17a-11 pertaining to material inadequacies.

4.65 In reporting on a broker or dealer exempt from rule 15c3-3, the “Computation for Determination of Reserve Requirements Under Rule 15c3-3” and the schedule of “Information for Possession or Control Requirements Under Rule 15c3-3” are inapplicable. In lieu of those schedules, the independent auditor should include a section under which exemption is claimed. (With respect to the effect of the exemption on the “Independent Auditor's Supplementary Report on Internal Accounting Control,” see footnote 35 to exhibit I in Appendix A of this guide.)

Chapter 5

U.S. Government and Money Market Instruments

5.01 In addition to securities transactions involving the purchase and sale of corporate equity and debt securities, U.S. government, federal agency, and money market instruments (commercial paper, bankers' acceptances, certificates of deposit, and various forms of government securities, such as treasury bills and treasury notes) are becoming increasingly important to many brokers' and dealers' trading positions. Examples of these securities are given below. However, new types of securities are constantly being introduced; consequently, the list is not all-inclusive.

U.S. Government and Federal Agency Instruments

5.02 *Treasury Bills.* Treasury bills are direct obligations of the U.S. government and are issued in maturities of three, six, and twelve months and traded on an original issue discount basis.

5.03 *Treasury Bonds and Notes.* The bonds and notes are direct obligations of the U.S. government that bear a specific coupon interest rate. Treasury notes may be issued with a maturity of not less than one year nor more than ten years. Treasury bonds have a maturity in excess of ten years.

5.04 *Government Agency Securities.* Generally, government agency securities are direct obligations of a specific government agency and are not guaranteed directly by the U.S. government. These securities can be issued either on a discount basis or with a specific coupon interest rate. The more common government agency securities include instruments of federal intermediate credit banks, banks for cooperatives, federal land banks, and federal home loan banks.

5.05 *Government National Mortgage Association ("GNMA" or "Ginnie Mae") Securities.* These securities are fully guaranteed government securities that represent an interest in a specific pool of federal housing administration or Department of Veterans Affairs mortgages. The investor receives a monthly payment of principal and interest that is guaranteed by GNMA and backed by the full faith and credit of the U.S. government.

5.06 *Federal Home Loan Bank Mortgage ("FHLB" or "Freddie Mac") Securities.* FHLB securities are interests in residential conventional mortgages underwritten and owned by the Federal Home Loan Mortgage Corporation, which guarantees monthly payment of principal and interest.

Money Market Instruments

5.07 *Bankers' Acceptances.* Bankers' acceptances are drafts that the drawee bank has promised to honor at maturity; they constitute an irrevocable obligation of the bank. Acceptances are created to finance transactions in specific commodities or to facilitate dollar exchange transactions with foreign banks. The drawer of the draft, those who endorse the draft without qualification, and the accepting bank remain contingently liable to the investor for payment at maturity.

5.08 *Certificates of Deposit.* Certificates of deposit are obligations of the issuing bank to pay the beneficial holder or bearer the face amount plus interest at maturity.

5.09 Commercial Paper. Commercial paper consists of short-term promissory notes issued by corporations for any term, normally up to 270 days.

Principal Transactions in U.S. Government, Federal Agency, and Money Market Instruments

5.10 Transactions in U.S. government and money market instruments are initially recorded at cost or proceeds from a sale. For all such securities, inventory is valued at the current market price each period with the resulting unrealized gain or loss credited or charged to the results of operations. Thus, the current period's income generally includes unrealized gains or losses on mark-to-market of ending inventory and realized gains or losses on inventory positions liquidated prior to the end of the period. For purposes of income recognition, open transactions executed in the futures commodity markets (that is, futures for treasury bills, bonds, or notes) should be valued at the current market price, with the resulting unrealized gains or losses credited or charged to the current period's results of operations.

GNMA Principal Transactions

5.11 The following paragraphs relate specifically to GNMA transactions. However, the principles are the same as those for similar securities (for example, Federal Home Loan Bank Mortgages) and are not specifically addressed below.

Description and Trading Practices

5.12 When compared to other government-backed securities, GNMA modified pass-through securities are unique in that both a principal amortization and interest are paid on a monthly basis. In addition, each GNMA security has its own identifiable pool number even though such securities usually have the same coupon rate for more than one pool.

5.13 GNMA's are normally traded on a delayed delivery or forward basis. A time span of up to one year or more can exist between the trade and settlement dates. A very low percentage of trades is executed on a cash or same-day basis. Because of the delayed delivery trading practices, when a transaction is executed on a trade date basis, a stated interest coupon is specified under a specific pool number to be announced at a future date (TBA designation). The designation of a specific pool number is normally given within twenty days before the settlement date. Prior or subsequent to the settlement date, the inventory is assigned to specific customers, where applicable, at the forward purchase or sales price executed with that customer. Mortgage-backed securities can be traded on either a guaranteed or yield maintenance basis. Specific rules on delivery are followed that give specific tolerances on quantity, number of pools, coupon substitutes, and so forth.

Gain and Loss Recognition

5.14 The detailed information below discusses the accounting and auditing procedures for determining the proper prices to use to arrive at the current market value and various considerations pertaining to recognition of gains and losses, balance sheet presentation, internal control structure, and credit procedures on forward commitments. All such transactions should be marked to market on a current basis with the resulting unrealized gains or losses included in the current period's results of operations.

Forward Transactions

5.15 Forward transactions (forwards) are defined as existing trade date commitments with settlement dates subsequent to the end of the month. They may have a time differential of up to one year or more and are thus traded on a delayed delivery or forward basis. These transactions are normally recorded on memo records, such as a pending or when-issued file, which are confirmed on a regular basis similar to other customer positions that have settled. The accounting for these forward transactions is to recognize the gain or loss on a current basis (that is, by valuing the individual transaction on a current basis). Market price in mortgage-backed securities in the forward market is based on its coupon and settlement month. Inventory positions should be defined as the net position in each coupon for each settlement month and should not be paired or netted if they have different interest rates or settlement months. Even though such positions are netted, it should be noted that the credit worthiness of customers on the other side of each transaction should be evaluated.

Standby Agreements

5.16 A standby agreement results when one party agrees to “stand by” for a specified time in the future (normally up to one year) to purchase GNMA modified pass-through securities at a specific price designated on the date of the agreement. The buyer of the standby has the option (one-way) to make delivery or allow the agreement to lapse. The buyer communicates this intent to the prospective purchaser on or prior to notification date—normally two weeks to one month prior to the settlement date as defined in the agreement. As compensation, a fee that is normally nonrefundable is paid on the date of agreement. In effect, the fee to the potential purchaser is compensation for the option issued to the seller.

5.17 Since standbys are similar to other options, the accounting should follow that for other options. Accordingly, all standbys should be marked to market at any month-end. In some cases obtaining the market value of a standby may be difficult. An amortized cost basis or proceeds based on the time remaining until expiration basis, as well as other factors such as the price of the underlying securities and the liquidity of the market, should be used as a guide in estimating value. In addition, standbys can be paired with other standbys, but only if the terms are identical.

5.18 The preceding paragraphs discuss standbys that enable the holder to sell securities (in effect, a put). Similar accounting should be used for standbys that enable the holder to purchase securities (in effect, a call).

Transaction Expense

5.19 In addition to recognizing gain or loss on a trade date basis, all related expenses (such as salesman’s commissions and a provision for potential nonperformance) should be accrued when the gain or loss is recognized. Establishing provisions for losses relating to these future commitments should be based upon factors such as the broker’s or dealer’s historical experience, the amount of open commitments, and the type of customers with whom the broker or dealer has such commitments.

Auditing Procedures

5.20 The auditing procedures for settled positions on the stock record are similar to other positions, such as inventory, and should be included in the normal auditing procedures for the stock record. Because most settled posi-

tions are held by banks or are with other brokers or dealers and are normally significantly large positions, usually they will be confirmed in total. However, in some circumstances they could be confirmed on a test basis. Unsettled positions, such as GNMA delayed delivery contracts, should be confirmed also, possibly on a test basis. Consideration should be given to confirming on a test basis with other brokers and dealers to determine if all unsettled trades recognized by the other broker or dealer are included as unsettled positions by the client being audited.

5.21 In his review of client procedures in this area, the auditor should—

1. Determine that trades have proper approval.
2. Determine that trades are with customers or brokers or dealers who have been approved by appropriate client personnel. (This step is especially important for forward commitments.)
3. Review the total amount of forward commitments that settle in future periods. (Many brokers or dealers have limits on futures commitments with all customers.)
4. Determine that signed contracts are being obtained for forward commitments. If signed contracts are not being obtained, the auditor should determine how such commitments are being confirmed.
5. If applicable, review and evaluate client procedures for margin deposits.
6. Review the broker's or dealer's policies and procedures for evaluating the credit worthiness of its clients.

5.22 In (2), (3), and (4) above, the emphasis is on considering whether open commitments are with approved institutions or customers and whether such trades have been confirmed. This emphasis is necessary because the auditor needs to consider the likelihood of the transaction being completed. Unlike transactions that settle in five business days or less, long-term futures commitments have a greater potential for credit risk. If, for any reason, the transaction cannot be completed by the other institution or broker or dealer, it is important that the client be aware of its total exposure with each customer. Normally, with most futures commitments netting to small positions, there is minimum market risk if all parties perform their obligations; consequently, the emphasis in this area must be on the credit worthiness of the institution or broker or dealer on the other side of the transactions.

5.23 To test pricing the auditor normally would—

1. Review procedures used to price such instruments.
2. Determine the reasonableness of such prices as they relate to each other.
3. Review published prices, where possible. (In some instances, this will not be a viable procedure.)
4. Review the prices of recent transactions and relate them to the prices being used.
5. Confirm selected prices with independent market makers other than the client.
6. Review procedures designed to ensure that all principal and interest claims on GNMA's are being made.

5.24 In addition, as with any other interest-bearing security, accrued interest receivable and payable calculations should be tested.

Chapter 6

Option Transactions

6.01 Options for the purchase or sale of securities and indexes are listed and traded on several exchanges and are also arranged off the exchanges by put and call brokers or dealers. A *call* is an option that entitles buyers to purchase a fixed number of underlying units of a particular security at a fixed price per unit (exercise price) on or before a fixed date (expiration date). A *put* is an option that entitles the buyer to sell a fixed number of underlying units of a particular security at a fixed price per unit on or before a fixed date.

6.02 Numerous investment, hedging, and speculating strategies are followed by combining various put and call options with the same or varying numbers of underlying units, exercise prices, and expiration dates. Commonly used option combinations involving the same underlying security include—

- A *straddle*, which is a combination of one put and one call identical with respect to security issue, number of shares, exercise price, and expiration date.
- A *spread*, which is a combination of one put and one call covering the identical security issue, number of shares, and expiration date. The exercise price for the put is customarily slightly below the current market price, whereas the exercise price for the call is customarily above the current market price at the time the option contract is entered into.

6.03 To better understand the mechanics of option trading, refer to the glossary in this guide for descriptions of various terms used in conjunction with options.

6.04 An active public market has been developed in listed put and call options. For many years, there also has been an over-the-counter (OTC) market in options. The use of the OTC market for equity securities is currently limited. There are significant differences between listed and unlisted options. The discussion in this section principally deals with listed options, although some specific reference is made in certain areas to unlisted options.

Exchange Trading

6.05 Options traded on the exchanges are listed securities and therefore share the following similarities with other securities traded on exchanges:

- Orders to buy and sell options are handled through brokers in the same way as orders to buy and sell shares of stock.
- As in the case of listed shares of stock, exchange-traded option orders are executed on the floor of a national securities exchange where all trading is conducted on an auction basis.
- Market prices are generally readily available. However, the auditor should be aware that although market prices generally are readily available, for options that have not traded recently, the price listed

Note: The discussion in this chapter principally deals with listed equity options, although the basic principles are applicable to non-equity options and options on indexes. Each of the different types of options has specific exercise and position limits, customer reporting requirements, and margin requirements. The mechanics of trading options on debt instruments, foreign currencies, indexes, as well as options on equity securities, are similar and those items discussed hereafter apply to all listed options traded. See chapter 7 for a discussion of options on commodities.

in various sources (which is the price of the last trade) might not reflect the true market value at the date of the financial statements. The amount the buyer pays and the writer receives (the premium) reflects factors such as the remaining life of the option, the difference between the exercise price and market price of the underlying security, the level of interest rates, the price volatility, and other characteristics of the underlying security.

6.06 Each listed option is normally for a specified number of a widely held, actively traded underlying unit.⁶ The exercise or *striking price* is the price at which the call option buyer can purchase or the put option buyer can sell the underlying unit. All options have a specific expiration date, which is the last day on which the buyer is entitled to exercise his option to buy (call) or sell (put) the underlying unit. Expiration dates of certain classes of options (options of the same type covering the same underlying unit) and exercise prices are established by the exchanges on which they are traded. The expiration months generally are set at standard three-month intervals.

6.07 Options are traded in the nearest three of the four expiration months. Thus, for a given unit there may be simultaneous trading in as many as three options with identical exercise prices but with different expiration dates. It is also possible to have trading in options with a common expiration date but with different exercise prices. This difference arises because additional options with higher or lower exercise prices are introduced whenever there is a significant change in the market price of the underlying security. Equity option exercise prices are generally fixed at \$5 intervals. The option expiration date is generally the Saturday following the third Friday in the expiration month.

Options Clearing Corporation

6.08 The Options Clearing Corporation (OCC) is the issuer of the options traded on the exchanges and also serves as the clearing agency for option transactions. The OCC is the obligor on all option contracts. Once there are matching orders from a buyer and seller and the premium is paid, the OCC becomes the seller to the buyer and the buyer to the seller. This unique and complex rule is fully described in the OCC prospectus. All listed option transactions are required to be cleared through clearing members of the OCC. The transactions cleared by a clearing member are classified as either firm, market maker, or customer transactions. These classifications are used to determine the margin and collateral obligations for clearing members of the OCC. Collateral obligations are satisfied with customers' securities, letters of credit, or other acceptable collateral.

6.09 The OCC has organized trading in options so that for every outstanding option there is a buyer and a writer. When a buyer or writer makes an option trade, he is required to indicate whether the trade is an "opening" or "closing" purchase or sale transaction. An opening purchase transaction is a transaction in which an investor becomes an option holder. An opening sale transaction is a transaction in which an investor becomes an option writer. Closing transactions are trades that offset the trader's preexisting option position. A closing purchase transaction terminates the obligation of an option writer, and a closing sale transaction liquidates the position as an option holder.

⁶ Equity options represent 100 shares of stock; debt options represent varying units of U.S. Treasury obligations; foreign currency options represent varying amounts of a particular foreign currency; and index options represent a portion of the underlying index.

6.10 The OCC maintains a daily record of options issued in each of the accounts of its clearing members, and each clearing member is required to maintain a continuous record of his respective firm, market makers, and customer positions in options. The ownership of options is evidenced by the confirmations and periodic statements received from OCC or its clearing members.

6.11 Because an option purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the OCC by the timely submission of an exercise notice by the clearing member acting on behalf of the exercising holder. The exercise notice is then assigned on a random basis by the OCC to a clearing member acting on the behalf of a writer of an option of the same series (having the same exercise price, expiration date, and unit of trading) as the exercised option. The member is then obligated to deliver the underlying security against payment of the aggregate exercise price.

6.12 If the OCC assigns an exercise notice to a member's customer account, the member is required to allocate the exercise notice to a customer maintaining a position as a writer in the account. The member may use any fair and equitable method it chooses in the assignment of customer put and call writers' accounts; however, the method of allocation must be predetermined and reported to the exchange. The exercise settlement date is the fifth business day following the date of the exercise notice assignment for equity options, and varies according to the different types of non-equity options.

6.13 All options transactions on the exchanges are processed through an exchange specialist, a market maker, a floor broker, or an order book official—all of whom clear the transactions through one of the clearing members. Various option exchanges match the daily trade information and issue (on the same evening) an unmatched trade report to each clearing member, listing clearing member trades for the day for which the option exchange did not receive a matching record from another clearing member and all trades reported by other clearing members for which the clearing member submitted no matching record. In order to resolve any differences and submit any corrections or adjustments, the clearing members have until approximately noon of the following day to meet with the other clearing members. Any unmatched trades remaining after these corrections or adjustments are considered void and can be reentered only if both clearing members enter into another trade.

Unlisted Options

6.14 Unlisted put and call options on securities normally are written on a standardized contract form. Usually, an individual desiring to purchase an option will contact his broker or dealer and request a market quotation on the cost of the option. The broker or dealer ordinarily will contact an active put and call broker or dealer, who in turn will contact an individual who has previously expressed an interest in selling options of the type required. Assuming that mutually satisfactory terms can be arranged, the option contract will be written, endorsed (guaranteed), and delivered to the purchaser.

6.15 Unlisted options are written infrequently and may be written on listed or OTC securities, at any price and for any duration. They are generally written at the current market price at the time of entering into the contract, for periods of thirty days, sixty days, ninety days, six months, or longer.

Accounting for Option Positions

6.16 The market or fair value of options fluctuates as the value of the underlying security changes and as the remaining time to expiration decreases. Brokers and dealers carry all securities at market or fair value, and it is appropriate that option positions also be reflected at market or fair value. The cost or proceeds from sales of options are subsequently adjusted to the current market (marked-to-market) or fair value of the options, and as in the case of other securities, any gain or loss is included in the results of operations. The current market value of exchange-traded options generally should be based on the quoted bid and offer prices. The fair value of unlisted options should be determined by the broker's or dealer's management, which considers the price of the underlying securities, the liquidity of the market, and time remaining to expiration date. The process of adjusting option positions to market or fair value gives appropriate accounting recognition to the option premium.

Auditing Option Positions

6.17 Option positions in customer or proprietary accounts of the brokerage concern are carried in the same manner as other securities. (For example, purchased put or call options are carried as long positions, and sold or "written" options are carried as short positions.) In the case of options, however, the description in the option department records also includes the exercise price and date of expiration.

6.18 In general, the audit of options involves testing option positions of customers, market makers, other brokers or dealers, and correspondents, and positions with the OCC. The audit also involves considering the relevant internal control structure policies and procedures, testing related money balances, testing valuation of option positions in proprietary accounts, confirming letters of credit and margin deposits, determining compliance with margin requirements of the NASD and the various exchanges, and the requirements of Regulation T.

6.19 The auditing procedures are essentially the same as those used to test other security positions and money balances. Option positions can be tested by confirming customer positions and balancing positions as reported by the clearing corporation (for listed options), examining endorsed papers (for unlisted options), confirming with correspondents, and so forth. Customers' option positions normally are confirmed simultaneously with confirmations of customers' security accounts. Security positions and accounts of market makers and other brokers and dealers also can be confirmed along with normal confirmation procedures for those accounts.

6.20 Listed options normally are traded by a broker or dealer through a correspondent or clearing member of the OCC. Since listed options are not evidenced by a certificate, option positions are carried by the clearing member for the broker or dealer until the option is closed out or has expired. Therefore, street side positions for listed options are confirmed with the OCC organization or the carrying broker.

6.21 The OCC has established procedures for the daily balancing of all option positions with its members. In the daily balancing of option transactions, it is an extremely important control procedure that a distinction be maintained between opening and closing transactions and that a reconciliation be made of the gross positions. The mere balancing of net positions could result in failure to take timely action to exercise or cover an option position. (For instance, the broker or dealer could fail to exercise a long option, whereas the

offsetting short position could be called by the holder, thereby resulting in a substantial loss to the broker or dealer.)

6.22 The audit procedures for clearing brokers should include a review and selected tests of the balancing procedures during the audit period.

6.23 Unlisted purchased options are evidenced by endorsed “papers” on hand in the “box” or are included in the account of the correspondent broker through which the broker placed its option order. Therefore, the papers are examined, confirmed, and balanced in the same manner as securities.

6.24 Unlisted sold options can be confirmed in the same manner as a security if the option sale order is placed through a correspondent. If the broker endorses its customers’ options and delivers them to the purchasers, either directly or through put and call brokers, the identity of the purchaser is usually unknown and confirmation may not be possible. The endorsing organization must maintain a record of endorsed papers, and sold options can be tested by comparing them to this record. The customer side of the endorsed option can be confirmed in the same manner as a security and can be balanced against the record of endorsed papers. Since sold options represent commitments of the broker or dealer, the review of controls in this area should encompass the accounting control procedures to record all such transactions.

Margin Requirements

6.25 With respect to each option for which it represents the writer (short positions), a broker or dealer that is a clearing member of the OCC is required to either deposit the underlying security (in the case of a call) or deposit and maintain specified margins (in the case of a put or call) with the OCC. (Specified margins include cash, U.S. government securities, and bank letters of credit, or equity securities at their present loan values.) The deposit of the underlying security is made with a bank, trust company, or other approved depository under agreements requiring delivery of the security against payment of the aggregate exercise price specified by the call. Such deposits may be made as a commingled deposit for securities of a number of customers. In lieu of the deposit of the securities, a broker or dealer may file with the OCC escrow receipts from approved banks. An escrow receipt is a representation by the issuing bank that a particular customer’s securities are on deposit with the bank and will be delivered upon exercise of the call for which the receipt was issued.

6.26 Regulation T and the rules of the NASD and the various securities exchanges of which the broker may be a member impose margin requirements pertaining to a customer’s position as an option writer; in addition, they impose requirements as to the minimum amount of margin that a customer must constantly maintain in a margin account.

6.27 As a result of the applicable margin requirements, all writing transactions (except in certain limited circumstances) are required to be conducted in a margin account (which ordinarily will be a general account under Regulation T). Brokers generally require option writers to enter into margin agreements that give the broker a lien on securities and other assets held in the margin account.

6.28 The margin requirements are subject to change. Special margin requirements may be imposed from time to time with respect to particular options, particular positions in options (such as certain spread positions), or particular accounts or customers. Under the current provisions of Regulation T, options have no loan value in margin accounts.

Net Capital Requirements

6.29 The net capital requirements of specialists, market makers, board brokers, and registered traders in options are very complex since they pertain to various combinations of offsetting positions in options and underlying securities. The requirements and specific capital charges are defined in SEC rule 15c3-1 and in published interpretations, which should be carefully reviewed for the specific circumstances and positions of the broker or dealer under audit.

Chapter 7

Commodity Futures and Option Transactions

Regulations

7.01 On October 23, 1974, the U.S. Congress passed the Commodity Futures Trading Commission Act. The act amended the Commodity Exchange Act (the Act) and created an independent Commodity Futures Trading Commission (CFTC), which replaced the Commodity Exchange Authority of the U.S. Department of Agriculture. The CFTC regulates all U.S. commodity futures markets, and its regulations appear in title 17 of the Code of Federal Regulations.

7.02 The CFTC's responsibilities include monitoring futures markets to detect and prevent commodity price distortions and market manipulations and protecting the rights of customers who use the markets for hedging or speculative purposes. The CFTC has adopted many new rules and regulations, certain of which pertain to the independent auditor's responsibility for the audit of the annual financial statements of commodities dealers, including futures commission merchants (FCMs), commodity pool operators (CPOs), and securities brokers and dealers who may be registered as FCMs or CPOs. Regulations have been adopted that require that FCMs file with the CFTC annual financial reports audited by independent public accountants. In addition, other regulations cover minimum financial requirements for FCMs and the formula used to determine whether such requirements are being met. Other regulations require that customer funds be segregated from those of the FCM and that the FCM make daily computations of the total amount of customer funds required by the Act and regulations to be segregated.

7.03 In addition to the regulation by the CFTC, Congress made provision for industry self-regulation by contract markets or commodity exchanges and by registered futures associations. Each contract market is required to develop rules and bylaws for its member FCMs, floor brokers, and floor traders. Further, each self-regulatory organization (SRO) is required to adopt and submit for CFTC approval rules prescribing minimum financial and related reporting requirements for all its members who are registered FCMs. Also, in the legislation establishing the CFTC, there were provisions for the CFTC to register and approve the rules of an industry self-regulatory association.

7.04 In September 1981, the CFTC registered and approved the rules of the National Futures Association (NFA), which is charged with industry self-regulation of FCMs, CPOs, and Commodity Trading Advisors that are members of the NFA. Copies of the audited financial reports of FCMs required to be filed with the SROs are also to be filed with the CFTC, and the CPOs that are members of the NFA are required to file such reports with the NFA and the CFTC. Also, at this time, the CFTC has proposed rules for the registration of introducing brokers, a CFTC registrant category. Although introducing brokers will not be allowed to carry customer funds, the CFTC will prescribe minimum financial and related reporting requirements, record-keeping requirements, and a requirement for filing annual financial statements reported on by an independent public accountant.

The Futures Market

7.05 Commodity futures contracts are commitments to buy or sell commodities at a specified time and place in the future. Hence, the name futures contract. The price is established when the contract is made in open auction on a commodity futures exchange approved by the CFTC.

7.06 Only a small percentage of futures trading actually leads to delivery of a commodity; a contract usually is liquidated before the delivery date. Market participants fall into two categories:

1. Commercial hedgers that use futures to minimize price risks inherent in their marketing operations by shifting that risk to speculators
2. Speculators that accept that risk in the hopes of profiting from price changes

7.07 Futures prices are an indication of the direction of commodity prices based on current market conditions. Hedgers and speculators that trade futures contracts are required to make margin payments or good faith deposits as required by the rules of the exchange on which such contracts are traded and by the FCM, which executes such trades.

7.08 Futures contracts for agricultural commodities have been traded in the United States for more than 100 years, and have been under federal regulation since the 1920s. In the law that established the CFTC, however, Congress, in order to meet a need for regulation of futures trading in a broader array of commodities, expanded the definition of commodity to include not only agricultural products but "all other goods and articles, except onions . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in. . . ."

7.09 In recent years, a number of new futures contracts have been approved, including contracts on a variety of financial instruments, foreign currencies, energy products, various stock-indexes, and exchange-traded options on certain futures contracts.

7.10 At present there are only two types of commodity options that can legally be offered and sold to the general public. Subject to certain conditions, a dealer (that is, a person who was in the business of buying, selling, producing, or otherwise using a physical commodity and who may continue to grant options on that commodity as of May 1, 1978) may grant an option on that physical commodity that may be offered and sold to a member of the general public by an FCM. The public customer deals directly only with the futures commission merchant; the grantor is not permitted to deal directly with the customers. The minimum financial segregation and record-keeping requirements for a dealer option grantor are set forth in section 32.12 of the CFTC regulations. FCMs who engage in dealer option transactions are also subject to segregation and record-keeping requirements.

7.11 Congress has authorized the CFTC to conduct a pilot program of exchange-traded commodity options. The CFTC has adopted regulations to govern a three-year pilot program for trading options on futures contracts; the program began in late 1982. The adoption of such regulations was made in conjunction with amendments to the CFTC's preexisting minimum financial, segregation, and record-keeping regulations to bring commodity option transactions within the CFTC's general regulatory framework.

7.12 In this chapter all references to options generally refer to exchange-traded options on futures on physicals; references pertaining to dealer options will be so noted.

Futures Commission Merchants

7.13 A futures commission merchant is defined in section 2(a)(1) of the Act as an individual, association, partnership, corporation, or trust that is engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that in or in connection with the solicitation or acceptance of orders, accepts any money, securities or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom. CFTC regulations make it unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as an FCM under the Act.

Requirements of Futures Commission Merchants

7.14 The minimum financial requirements for futures commission merchants are set forth in CFTC regulation 1.17. Because a substantial number of FCMs are also registered securities brokers or dealers, the CFTC and the SEC have acted to make each agency's minimum financial regulations and reporting requirements compatible, where possible. Therefore, a securities broker or dealer may file with the CFTC unaudited quarterly data in the form required by the SEC. (FCM members of certain commodity exchanges may file on a semiannual basis, as required by such exchanges, rather than quarterly as required by the CFTC and the SEC.) The audited filing with the SEC for a securities broker or dealer is also similar to that required by the CFTC. However, the report cover, the attestation, and procedures relating to nonpublic treatment of certain financial statements and supplementary schedules differ from those the SEC requires. The independent auditor should refer to CFTC regulations 1.10 through 1.17 to assure compliance. CFTC regulation 1.16(c)(5) requires the audited filing to include an accountant's report on internal accounting control. The report is filed with the CFTC in lieu of the report on internal accounting control required by SEC rule 17a-5.

7.15 While the requirements of such reports are similar in many respects, there are certain requirements of the SEC and the CFTC that are unique to those individual regulatory bodies. Although the auditor could modify the supplementary report required by the SEC to also meet the CFTC requirements, separate formats are provided to ensure compliance with the respective SEC and CFTC rules. (See exhibits J and K in Appendix A of this guide.) Except for the difference in the report on internal accounting control, the same audited financial report can be filed to meet both SEC and CFTC requirements.

7.16 Some of the regulations that govern FCMs are the registration requirements contained in sections 1.10 and 3.10 of the regulations, minimum financial requirements in regulation 1.17, and segregation requirements in section 4d(2) of the Act and regulation 1.20. The independent auditor should become familiar with these and other regulations, which are described below.

Minimum Financial Requirements

7.17 CFTC regulation 1.17 provides that each registered FCM is to maintain adjusted net capital equal to or in excess of the greatest of—

- \$50,000 (\$100,000 for each registered FCM that is not a member of a designated self-regulatory organization), or

- 4 percent of the following amount: the customer funds required to be segregated pursuant to the Act and the regulations, less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, provided, however, the deduction for each option customer shall be limited to the amount of customer funds in such option customer's account, or
- For securities brokers and dealers, the amount of net capital required by rule 15c3-1(a) of the regulations of the SEC.

Regulation 1.17(a)(2) further provides that the requirements shown above are not applicable if the FCM is a member of a designated self-regulatory organization (DSRO) and conforms to minimum financial standards and related reporting requirements set by the DSRO and approved by the CFTC. Regulation 1.17 also sets forth instructions on how the minimum financial requirements, or net adjusted capital, are to be computed. When an FCM's adjusted net capital falls below the levels specified in regulation 1.12, notification is to be given to the CFTC and the DSRO, if any. (See the reporting requirements section of this chapter.)

Segregation Requirements

7.18 Section 4d(2) of the Act and regulation 1.20 require that all customer funds be separately accounted for and segregated as belonging to commodity or option customers. Regulations 1.20 through 1.30 impose additional proscriptions on the accounting, handling, investment, and disposition of customer funds. Also, regulation 1.32 requires each FCM to make daily computation and records of the total amount of customer funds on deposit in segregated accounts, the total amount of such customer funds required by the Act and the regulations to be on deposit in segregated accounts, and the amount of the FCM's residual interest in such funds.

Record-Keeping

7.19 Part 1 of the regulations contains rules relating to the preparation and maintenance of records by FCMs.

Reporting Requirements

7.20 FCM reporting requirements are contained in regulation 1.10, "Financial Reports of Futures Commission Merchants." That regulation sets forth the requirements for filing an audited Form 1-FR with initial application for registration as an FCM, and unaudited interim Form 1-FRs and audited Form 1-FRs once the firm becomes registered. If the FCM is also a securities broker or dealer, it may comply with the filing requirements by filing a copy of its FOCUS report under the Securities Exchange Act of 1934, part II, in lieu of Form 1-FR, provided that all information that is required to be furnished with Form 1-FR is provided with the FOCUS part II. In addition, the CFTC has provisions for certain financial statements to be filed in connection with the early financial warning system of regulation 1.12, "Maintenance of Minimum Financial Requirements by Futures Commission Merchants."

Qualifications and Reports of Accountants

7.21 Similar to the SEC's regulations, the CFTC's regulations have specific requirements pertaining to the independent auditor's report on the annual reports filed by FCMs and CPOs. The CFTC requirements are set forth in section 1.16 of the regulations under the Commodity Exchange Act (the Act).

Commodity Pool Operators

7.22 A CPO is defined in section 2(a)(1) of the Act as “any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market.” Specific rules for regulating the activities of CPOs are set forth in part 4 of the regulations under the Act. The independent auditor should note that whereas the audit of an FCM covers the financial statements of the FCM, the audit for the CPO covers the financial statements required to be included in the annual report for each pool operated by the CPO.

7.23 Some of the requirements of regulation 1.16 apply to both audits of FCMs and audits of pools operated by CPOs, while other portions of the rule do not apply to audits of the pools operated by the CPO. In accepting an engagement and prior to performing the audit of a pool operated by a CPO, the auditor should become familiar with the CPO requirements under part 4. While certain sections of part 4 may have more direct impact on the audit of the pool, the auditor should evaluate the requirements of part 4 as they relate to a particular audit.

Reporting to Pool Participants

7.24 The independent auditor should obtain satisfaction that information and statements required by section 4.22 are presented in the pool's annual report. Section 4.22(d) states that the annual report of the pool must be audited in accordance with regulation 1.16 except that the following requirements of that section do not apply: (1) the audit objectives of regulation 1.16(d)(1) concerning the periodic computation of minimum capital and property in segregation; (2) all other references in regulation 1.16(d)(1) to the segregation requirements; and (3) regulations 1.16(c)(5), (d)(2), (e)(2), and (f). Also, the auditor should note that under paragraph (f)(1) of section 4.22 of the regulations, procedures are set forth for the CPO to request an extension of time when the CPO determines that he cannot file the audited annual report within ninety calendar days after the end of the pool's fiscal year. Paragraph (f)(2) of section 4.22 requires that a letter from the independent auditor accompany such request for extension of time for filing the report and further specifies the contents of the auditor's letter.

Record-Keeping

7.25 The CPO is required by section 4.23 of the regulations to maintain certain records, and the auditor should review those requirements when planning the audit.

FCM Operations

7.26 The commodity operations of an FCM, or the commodity department of a broker or dealer registered as an FCM, usually operate with independent units for the purchase and sale, bookkeeping, and margin functions. The commodity general ledger reflects all real and nominal accounts related to commodities. The general ledger usually includes a control account that represents the net balance in those commodity accounts. Separate ledger control accounts may be maintained for customers and noncustomers.

Commodity Transactions

7.27 Securities brokers and dealers that also deal in commodities generally engage in several activities. The larger brokers or dealers may act in the capacity of FCMs, CPOs, cash commission merchants, commodity merchandisers, and country and terminal grain elevator operators. Since commodity trading is a highly specialized activity, relatively few brokers or dealers engage in all of these activities.

7.28 Commodity transactions take many forms, the most prevalent being futures contracts, option contracts, cash forward contracts, fixed price commitments, and spot (cash or immediate delivery) transactions. A futures contract and a forward contract both represent the sale of a specified commodity for future delivery. A futures contract and an option contract can be distinguished from a forward contract and a spot contract by the purpose for which each is entered into, as well as the manner of establishing such contracts. Forward contracts and spot contracts are used in actually merchandising the commodity, while the purpose of a futures contract is to shift price risk (hedging) or to speculate in future price changes without actually making or taking delivery of the underlying cash commodity. Although forward and spot contracts can generally be entered into anywhere and at any time, futures contracts must be executed on or subject to the rules of a contract market that has been approved by the CFTC.

Underlying Commodities

7.29 The underlying commodities in commodity futures contracts traded today include grains, soybeans, rice, potatoes, sugar, coffee, and other foodstuffs; cotton; meat products, such as live and feeder cattle, pork bellies and live hogs, and broilers (chickens); precious and other metals, including gold, silver, copper, palladium, and platinum; foreign currencies; and energy products such as crude oil, heating oil, and leaded and unleaded gasoline. Contracts in financial instruments such as U.S. treasury bills, bonds and notes, GNMA securities, bank certificates of deposits and Eurodollars are also traded by those who wish to speculate or hedge using various "interest rate futures." More recently, stock index futures contracts have been introduced for hedging portfolios or speculating against overall changes in stock market prices. Most commodity futures contracts can be settled by taking or making delivery of the actual underlying commodity. Futures on stock market indexes and certain other futures are settled in cash. Exchange-traded options on futures contracts are required to be settled through delivery of the related futures contract by book-entry. Although a futures contract may be settled by delivery, virtually all of the commodity futures and option contracts are not settled by delivery, but rather with an offsetting purchase or sale of the same futures or options contract.

7.30 In the absence of a futures and option market for these commodities, food processors, millers, farmers, merchants, and other producers and users who must contract for or carry large physical quantities of these commodities would be subject to risk due to price changes. The futures and options markets, however, afford these users a means of price protection by enabling them to hedge the physical quantities in either their raw or finished state.

Hedging

7.31 In its simplest form, hedging involves simultaneously purchasing the physical commodity to replenish inventory and entering into a futures contract for the sale of the commodity for delivery at some future date. Theoretically, physical (spot) inventory is accumulated, and short futures contracts

are entered into (sold) to hedge against price fluctuations. As the physical inventory of the commodity is sold, the futures contracts are closed by buying in the same futures contracts, thereby offsetting the previous sales contracts. Through proper application of futures or option transactions, commodity users can avoid a large part of potential losses caused by fluctuations in the market price of the commodity.

7.32 Although price protection is the basic purpose of the futures and options market, the speculator plays a major role in making an efficient market. The speculator assumes the risk of price changes, which provide the speculator an opportunity for profit.

Regulations

7.33 The CFTC regulates commodity futures and options transactions and has the authority to promulgate rules and regulations for the industry. Some of the provisions of the regulations and exchange rules limit for each commodity the quantities of futures and option contracts that any one person may acquire and require daily reporting of trading activity by FCMs when customers' open positions reach a certain level. The segregation regulations restrict an FCM's use of customers' funds deposited to margin futures and option contracts.

7.34 In addition to federal government regulations, FCMs are requested to conform to the requirements of the various contract markets (or exchanges) and associated clearing organizations of which they are members. These self-regulatory organizations are similar in nature to securities exchanges in that they maintain and provide a marketplace for buyers and sellers and establish standards to assure orderly trading, and establish various record-keeping requirements applicable to the handling of commodities accounts and the execution of customers' orders. Unlike securities exchanges, however, commodity exchanges have set maximum daily price fluctuations for most commodities. In addition, FCMs that are members of NFA, an organization similar in nature to the NASD, are required to conform to NFA's requirements.

7.35 The various exchanges have rules and regulations that require minimum initial margin deposits and minimum maintenance margin levels, depending on the commodity bought and sold. While the broker or dealer may establish its own requirements depending on the financial capability of a particular customer, the requirements should not be less than the minimums set by the exchanges. Margin rates differ for each commodity and purpose for which a futures or options trade is made (that is, hedging or speculating). In periods of market volatility, generally accompanied by high volume, the exchanges frequently increase margin requirements. However, margin rates are subject to reduction or restoration to their previous level when market conditions warrant a change.

7.36 In addition to initial margin requirements, maintenance margin (referred to as variation margin) requirements are commonly prescribed by the exchanges. Any impairment of the initial margin deposit due to price fluctuations below the maintenance margin level set by the exchange requires the customer to meet a margin call. In most cases the call is required to be sufficient to restore the margin to the initial margin level. If the margin call is not met within a specific period of time (hours or days), the customer's open futures or option position should be liquidated to the extent necessary to bring his account back to a status that conforms to the margin requirements.

Execution of Trades

7.37 Execution of orders for commodity futures and option trades by brokers or dealers registered as FCMs is somewhat similar to the handling of stock orders. A broker or dealer registered as an FCM and a clearing member of a contract market clears trades executed by its floor brokers through that clearing organization. A broker or dealer who is not a clearing member of a contract market clears its trade through a clearing member in an omnibus account. Once two brokers or dealers have entered into a contract to buy or sell a commodity future, the clearing organization acts as the contra party in clearing and settling the transaction. In effect, the clearing organization acts as a substitute for the other broker that is a party to the transaction.

Accounting for Commodity Futures Transactions

7.38 Accounting for a commodity futures transaction differs somewhat from that for a securities transaction. While a confirmation of the trade is submitted to the customer showing the pertinent price, quantity, and commodity data, no monetary entry is made for the underlying value of the commodity. A cash entry is made to the customer's account for the amount of the premium or deposit paid or received. The customer's account reflects this cash ledger balance, any securities pledged as margin for the futures and option transactions, and the open futures and option contracts in the commodities traded. Adjustments for changes in market value are generally maintained in a memorandum account, which provides the mechanism for determining when additional margin is required or when excess equity is available.

7.39 At the close of each business day, the commodity exchange publishes for each contract the settlement price (that is, market price) to which all open contracts should be adjusted (that is, marked-to-market). Specifically, all newly executed and open contracts are listed together with the quantity, contract's trade price, and the contract's settlement price for that day. All open contracts from the previous trading days are compared with the settlement price of the previous day and the current day's settlement price. The net price difference (gain or loss) is settled in cash with the clearing organization. The broker or dealer records the unrealized gains or losses from the daily settlements in a settlement (or contract difference) account. After closing or offsetting transactions (round turns) have been completed, the gains and losses, net of commissions, are transferred to the customer's financial ledger account. Certain FCMs may also post the unrealized gains or losses on open contracts directly to the customer's financial ledger.

7.40 The clearing organization establishes the standing dollar amount of margin that the FCM is required to deposit to guarantee its open trades. The amount of margin is based on the number of open futures and option contracts, and it may be deposited in the form of cash, letters of credit, or U.S. government obligations. (While most clearing organizations accept letters of credit from their clearing FCM members, many exchanges do not allow their FCM members to accept letters of credit for margin from customers. The obligation to the clearing organization for margin is an obligation of the clearing FCM member.) Also, at certain clearing organizations, funds are deposited by the clearing FCM member with a bank, which then issues a margin certificate as evidence that margin has been deposited for the benefit of the clearing organization. The margin certificate is also evidence of the bank's agreement to pay margin in that amount on the demand of the clearing organization. The funds may only be released to the FCM with the consent of the clearing organization.

7.41 All funds deposited by customers and all funds accruing to customers as a result of commodity futures contracts are required to be accounted for separately and deposited in separate accounts with banks, exchange clearing organizations, or other FCMs. Pursuant to regulation 1.20, such accounts are to be designated as a segregated customers' funds account. Customer funds may also be invested in "qualified securities" under regulation 1.25, which limits such investments to obligations of the United States, general obligations of any state or political subdivision, or obligations fully guaranteed as to principal and interest by the United States. When such investment of customer funds are made in such forms, the resulting securities are required to be segregated for the benefit of customers, although income derived from the securities accrues to the FCM broker or dealer. In addition, customers may deposit securities (or other property) in lieu of cash margin. Such securities are also required to be segregated, although any earnings from such securities accrues to the depositing customer. The total amount of customer funds required to be on deposit under the Act and the FCM's residual interest, if any, in such customer funds is required to be computed as of the close of the market each business day. The computation is required to be made prior to noon of the following business day.

7.42 In determining the amount of customer funds required to be segregated, a deficit in the account of one customer cannot be offset against the equity of another customer. Separate accounts should be kept for customers trading in both regulated and nonregulated (foreign market and cash) commodities because the Act prohibits commingling of funds. Funds may be transferred between the various types of a customer's accounts with the customer's authorization. The independent auditor should determine whether procedures are in effect that permit proper identification of qualified securities as margin deposits in order to prevent such securities from being used for other purposes. The CFTC does not establish margin requirements for futures contracts; margin levels are set by the various exchanges. However, the system of payment and collection of option margins are subject to CFTC approval. The Act specifies that customer funds deposited in accounts designated as regulated commodity accounts may be used to margin such customers' regulated commodity positions.

7.43 Brokers and dealers that are also FCMs are required to file with the SEC and CFTC on a quarterly basis, with part II of the FOCUS Report, a schedule of segregation requirements and funds in segregation for customers' regulated commodity futures and option accounts. (Exhibit H, schedule IV in Appendix A of this guide shows the schedule required to be filed with the SEC and CFTC.)

7.44 Many brokers and dealers, particularly those located outside the exchange cities, do not have membership privileges, or are not clearing members of a given commodity exchange, but place their commodity transactions through correspondent brokers or dealers that are FCMs. In those instances, the accounts of the broker or dealer may not contain a settlement (or contract difference) account since the offset to purchases and sales of commodity futures transactions will be in the account with the correspondent broker or dealer if the account is carried on an instruct basis. An instruct basis is a method of clearing transactions in which the originating broker specifically instructs the correspondent broker which trades are to be offset. A contract difference account should be used if the account is carried on a non-instruct basis to provide reconciliation between the books of the originating broker and the carrying broker. The originating broker accounts for its numerous customer trades on a specific identification basis, and the carrying

broker records these same customer transactions in the originating broker's omnibus account on a FIFO basis. Therefore, the respective gain or loss between the originating and carrying brokers will differ at any given point in time. This difference is accounted for by the balance in the contract difference account of the originating broker. When the FCM carries commodity futures or commodity option contracts for another FCM on an omnibus account basis, CFTC regulations require that such omnibus account be margined on a gross basis.

Auditing Commodity Accounts

7.45 Auditing procedures applicable to commodity accounts do not differ substantially from those relating to securities accounts. Procedures that should be applied, as appropriate, include considering the relevant internal control structure policies and procedures, balancing of positions, margining, inspecting documents, and reviewing account classification and compliance with CFTC segregation and net capital requirements.

7.46 The auditor should be familiar with the Act and the related regulations, including the most recent amendments, as well as the pertinent rules of the NFA and the applicable contract markets and clearing organizations, and the published Financial and Segregation Interpretations of the CFTC's Division of Trading and Markets. He should have an understanding of the following areas that are unique to the commodity department.

Clearing Organization for Settlement of Commodity Futures and Option Contracts

7.47 A clearing organization is affiliated with a commodity exchange to clear or match trades executed on that exchange. The clearing organization, which is composed of clearing members, prepares daily settlement reports for each member. The reports show details of the trades cleared and original margin on futures or premium deposits on options separately for customer and noncustomer trades. The open trades at the close of business each day are marked-to-market (trade price versus settlement price), resulting in a net cash payment to, or collection from, each clearing member as a result of price changes (that is, gains or losses). The payable or receivable is settled by check, draft, or wire transfer prior to the opening of the market the next business day. In addition, the clearing organization may call on the clearing member for additional original margin. The margin and option premiums deposited at the clearing organizations are kept under the control of such clearing organizations as a guarantee against defaults.

7.48 The independent auditor should consider confirming positions open with the clearing organizations and the amounts receivable or payable on settlements and the aggregate amounts of original margin. The auditor should also consider reviewing subsequent clearing sheets for a selected number of days after the date of the financial statements for trades executed as of the date of the financial statements, but not cleared until a later date. Generally, such trades (frequently referred to as *out trades* or *hold outs*) are cleared by the fifth business day following the trade date, with most clearing the first business day after such dates. The auditor may consider it useful to obtain a report on policies and procedures placed in operation (and tests of operating effectiveness) at the clearing organization. (See SAS No. 70.)

Spot (Cash) Commodities in Physical Possession

7.49 Spot commodities ordinarily are represented by warehouse receipts or bills of lading, although some commodities such as gold, silver, or platinum

may be in the physical possession of the broker or dealer that is an FCM. The documentary evidence of ownership of such commodities may be in the possession of the broker or dealer, or it may have been deposited with a lender with whom evidences of ownership are pledged as collateral.

7.50 The independent auditor should consider examining warehouse receipts and bills of lading in the physical possession of the broker or dealer and tracing into the records any entries relating to such documents that may be in transit between offices of the broker and dealer at the date of the financial statements. Written confirmation of material amounts should be obtained from the warehouses, and confirmations should be obtained from lenders regarding any documents that may have been pledged as collateral for loans. The auditor should be aware of the guidance provided by SAS No. 1, section 901, as revised, *Public Warehouses—Internal Control Structure Policies and Procedures and Auditing Procedures for Goods Held*, for commodities held by public warehouses.

7.51 The auditor's test of inventory should include physical observation, and test counts or weighings of commodities in the FCM's physical inventory, and he should take whatever steps are necessary under the circumstances to satisfy himself concerning the types and grades of commodities.

Accounts Carried by Other Brokers and Dealers in Commodities

7.52 If a broker or dealer that is an FCM trades in commodities for which transactions are executed on a commodity exchange of which the broker or dealer is not a member, it probably maintains open accounts with those who are members of that exchange. These accounts are referred to as carrying or correspondent brokers' accounts, or omnibus accounts. As of a given date, like other commodities accounts, they show a debit or credit money balance, any securities pledged as margin, and commodity positions either long or short.

7.53 The auditor should consider requesting from such other carrying brokers or dealers, with whom accounts are maintained, a statement of the account showing any cash balance, securities or open commodity positions long or short. These statements should be compared with the records of the broker or dealer under audit. To facilitate this effort, the auditor may mail a statement of the account to the carrying broker, requesting confirmation of the balance and any open positions together with any adjustment subsequent to the account statement date.

Customers' Commodity Accounts

7.54 Customers' commodity accounts fall into two general classes: nonregulated accounts such as spot (cash) commodities' positions of foreign futures contracts and regulated open futures and option contracts. Only futures and options transactions come under the CFTC's segregation requirements.

7.55 If written requests for confirmation of the balances and positions in accounts are deemed appropriate, they should be mailed directly to customers in a manner similar to that followed for customers' securities accounts. (See chapter 4 for a discussion of the timing of auditing procedures.)

Accrued Commodity Commissions Receivable and Payable

7.56 Accrued commodity commissions receivable and payable represent commissions due from customers or due to other brokers on half-turn transactions (open long and short positions). With respect to exchange-traded options, some FCMs may charge the commissions when the option is first put on, while other FCMs may have a fixed charge for the option that allows the customer to

either execute the option, let it expire, or offset it by another like-option similar to offsetting futures contracts. Such charges can be tested by reference to the broker's or dealer's commission schedule. Since the broker or dealer has performed all of the required services and incurred the costs of earning one-half of the round turn commissions on open commodity positions, such commissions should be accrued, even though they are not billed to customers until the position is closed. Similarly, any commissions due correspondent brokers on open commodity positions cleared through such brokers should be accrued.

Commodity Daily Settlement Accounts

7.57 The settlement account balance represents an accumulation of checks paid to or drafts received from various clearing organizations as a result of "variation margin." In addition, the account is used to transfer to customers' financial ledger balances gains or losses that result from P&Ss (purchases and sales that close out trades). (The variation margin is the change in the mark-to-market valuation of futures transactions between the previous trading day and the current day and between the trade price and the settlement price on the day of trade. The balance may be a debit or credit depending on the direction and magnitude of price changes.) This account should be reconciled to the point balance, which is a calculation of all open trades marked-to-market. Also, the FCM's open trade positions should be reconciled to the open trades shown on the clearing sheets or correspondent brokers' confirmations. The independent auditor should note that some clearing organizations record the FCM clearing member's trade on a gross basis, while others clear on a net basis. Thus, if trades are cleared on a net basis, the FCM should consider such a fact in reconciling the FCM's trades to the clearing organization's report of open trades.

Commodity Exchange Fees

7.58 Commodity exchange fees are fees due from the exchange members to various clearing organizations for execution of trades. This account should be analyzed and consideration given to reconciling the payable to information received from clearing organizations. Firms that are members of NFA may also have a liability for transaction fees payable to NFA.

Commodity Brokerage Payable

7.59 The commodity brokerage payable account represents brokerage fees due to other brokers for trades executed by them on the floor of the exchange for the broker's or dealer's account. Auditing procedures for these payables may include confirmation and comparison of the bills for the current month with payments subsequent to the financial statement date.

Balancing Commodity Futures Positions

7.60 Commodity positions are balanced in the same way as securities positions. The clearing organization classifies transactions into two broad categories and issues separate daily reports for each category: *customers' trades* and *house trades*. The house classification includes all proprietary accounts. Positions in these accounts may be compared to copies of the clearing sheets and to statements received from correspondent brokers. At least monthly, the broker should prepare a schedule in commodity sequence that includes each commodity futures contract by month of contract maturity together with extended contract values and market values and the resulting unrealized gain or loss. This schedule sometimes is called a *point balance* or open position listing. The gains and losses shown should be in agreement with the settlement accounts. In addition, the open long and short trades in the

open position listing should be balanced against the positions of the clearing organization and correspondent brokers.

Valuation of Commodity Futures and Option Contracts

7.61 Open commodity contracts should be marked to the current market value as of the close of business of the date of the financial statements under audit.

7.62 Because both exchange-traded options and futures transactions are governed by the same segregation provision, the segregation and accounting treatment of options is similar to the segregation and accounting treatment for futures. Accordingly, an FCM will be required to mark each of its option customers' accounts to the market each day.

Margining of Customers' Commodity Accounts

7.63 Because of the volatility of the futures and options markets and the significant amounts of funds involved, the independent auditor should be particularly concerned with the procedures and controls pertaining to the extension of credit to customers, including trading limits, daily monitoring of accounts, and prompt follow-up of margin calls.

7.64 It is necessary to review the margining of customers' commodity accounts for purposes of computing capital requirements under SEC rule 15c3-1 and CFTC regulation 1.17 or commodity exchange and NFA requirements, as well as for determining exposure. CFTC rule 190.06(d)(1) requires that FCMs solicit instructions from each customer undertaking its first hedging contract concerning preferred treatment of its contracts in the event of the FCM's bankruptcy. The customer may prefer that any open commodity contracts held in a hedging account be liquidated without further instruction. The FCM should indicate any such customer preference in the accounting records in which it maintains open trade balances. This rule provides a basis for determining whether a particular account is traded for hedge or speculative purposes. Further, FCMs generally require a customer to declare hedge status by filing a letter of statement declaring it as such. Accordingly, the independent auditor should consider account status (hedge or speculative) in assessing the extent to which the trading accounts are meeting the respective hedge or speculative margin requirements.

7.65 In evaluating the adequacy of the margin in customers' commodity accounts, the total equity in the account is compared to the margin required by the commodity exchanges for the various types of commodities carried in the account.

7.66 The following information is helpful in testing the margining of commodity accounts:

- In-house margin requirements of the FCM and the latest margin notice issued by the applicable contract market
- List of customer and noncustomer accounts with margin deficiencies
- List of customer and noncustomer accounts showing open contracts, equity and outstanding margin calls.

7.67 Consideration should be given to reviewing customer and noncustomer accounts with margin deficiencies for transactions subsequent to the margin call date, in order to determine whether outstanding margin calls, if any, have been satisfied or positions have been liquidated and to determine if there should be charges to earnings.

Appendix A

Financial Statement and Other Exhibits

The financial statements required to be filed under FOCUS and by most regulatory agencies are not required to be in comparative form, and the accompanying financial statement exhibits are not prepared on that basis. However, it is preferable that brokers and dealers present financial statements on a comparative basis. With comparative financial statements, there is no need to present the supplementary information on a comparative basis.

The accompanying financial statement and schedule exhibits including the facing page and oath or affirmation form from Form X-17A-5 are illustrative only and have been prepared to show how various items might be presented, assuming they are material in the particular circumstances. In the usual situation, several items may not be included while some of those that are included might well be combined and presented as a single item.

The accompanying exhibits also include illustrative auditor's reports on internal accounting control, auditor's report on the SIPC annual assessment, and client representation letter.

The notes to the financial statements are representative of the basic type of disclosure for a broker or dealer in securities. Additional disclosures, such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, concentrations of credit risk, the fair value of financial instruments, and other matters not unique to brokers and dealers in securities may be required by generally accepted accounting principles.

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20540

**ANNUAL AUDITED REPORT
FORM X-17A-5
PART III**

FACING PAGE
Information Required of Brokers and Dealers
Pursuant to Section 17 of the Securities
Exchange Act of 1934 and Rule 17a-5 Thereunder

SEC FILE NO.
8- 12345

REPORT FOR THE PERIOD BEGINNING 1/1/X1 AND ENDING 12/31/X1
MM / DD / YY MM / DD / YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER:

Standard Stockbrokerage Co., Inc.

Official Use Only

FIRM ID. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS:
(Do not use P.O. Box No.)

1 Main Street

(No. and Street)

New York

New York

10004

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Joseph P. Brokestock

(212) 000-0000

(Area Code -- Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*

(Name -- if individual, state last, first, middle name)

Accounting Firm

2 Main Street

New York

New York

10004

(ADDRESS)

Number and Street

City

State

Zip Code

CHECK ONE:

- ☒ Certified Public Accountant
☐ Public Accountant
☐ Accountant not resident in United States or any of its possessions.

FOR OFFICIAL USE ONLY

* Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption.
See section 240.17a-5(a)(2).

SEC 1410 (1-79)

-2-

OATH OR AFFIRMATION

I, Joseph P. Brokestock, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Standard Stockbrokerage Co., as of December 31, 1981, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

Security accounts of principal officers and directors
that are classified as customer accounts
(debts \$316,513, credits \$273,412)

Signature

Subscribed and sworn
 to before me this
 ____ day of ____ 19X2

Vice-President - Finance
 Title

Joseph P. Notary
 Notary Public

This report ** contains (check all applicable boxes):

- ☒ (a) Facing page
- ☒ (b) Statement of Financial Condition
- ☒ (c) Statement of Income (loss)
- ☒ (d) Statement of Changes in Financial Condition
- ☒ (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital.
- ☒ (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
- ☒ (g) Computation of Net Capital
- ☒ (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
- ☒ (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
- ☒ (j) A Reconciliation, including appropriate explanation, of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
- ☐ (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
- ☒ (l) An Oath or Affirmation
- ☒ (m) A copy of the SIPC Supplemental Report
- ☐ (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.
- ☒ (o) Independent auditor's report on internal accounting control.
- ☒ (p) Schedule of Segregation Requirements and Funds in Segregation - Customers' Regulated Commodity Futures Accounts Pursuant to Rule 17a-5.

** For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

Note: Various exchanges may require a different form of oath or affirmation.

Exhibit A

Independent Auditor's Report

Board of Directors

Standard Stockbrokerage Co., Inc.:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.⁷

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

New York, New York
February 15, 19X2

GAAP Departure—Unsupportable Valuation

If securities and investments that are not readily marketable are material, it will be necessary to review the procedures and underlying documentation supporting the valuations. If the auditor concludes that the valuation procedures are inadequate or unreasonable or the underlying documentation does not support the valuation, he or she may need to issue a modified opinion because of a departure from generally accepted accounting principles. Follow-

⁷ See the discussion on the "Financial and Operational Combined Uniform Single Report" in paragraphs 2.01 through 2.09 for information on obtaining confidential treatment of the financial statements from the SEC.

ing is an example of a qualified opinion (assuming the auditor cannot reasonably determine the effects of the departure).

Independent Auditor's Report

Board of Directors

Standard Stockbrokerage Co., Inc.:

[Same first and second paragraphs as in the first report illustrated in this exhibit.]

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to \$10,730,685 (27 percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine fair value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.⁸

In our opinion, except for the effects on the financial statements of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.⁹

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects on *[identify the schedules affected]* of the valuation of investment securities determined by the Board of Directors, as described in the second preceding paragraph, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

New York, New York
February 15, 19X2

Explanatory Paragraph for Uncertainty of Valuation

The auditor might conclude, based on his or her review of management valuation procedures and the underlying documentation, that in the circumstances, the procedures appear to be reasonable and the documentation appropriate, but that there exists an inherent uncertainty because the range of possible values is significant. In such cases, the auditor may need to add an

⁸ SEC regulations require auditors to state if they have reviewed the procedures applied by the directors in valuing the securities, if they have inspected the underlying documentation, and if they believe the procedures are reasonable and documentation appropriate.

⁹ In certain circumstances, depending on materiality, the qualification could apply only to the income statement.

explanatory paragraph to the report because of the inherent uncertainty. For a further discussion of valuation of securities and investments that are not readily marketable, see the SEC's *Codification of Financial Reporting Policies*, section 404. Presented below is an example of an auditor's report in which the uncertainty is discussed in an explanatory paragraph.

Independent Auditor's Report

Board of Directors
Standard Stockbrokerage Co., Inc.:

[Same first, second, and third paragraphs as in the first report illustrated in this exhibit.]

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to \$10,730,685 (27 percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation, and in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the Board of Directors' estimate of fair values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material.

[Same paragraph reporting on supplementary schedules required by the Securities and Exchange Commission as in the first report illustrated in this exhibit.]

Accounting Firm

New York, New York
February 15, 19X2

Note: SEC regulations require the auditor to state if he has reviewed the procedures applied by the directors in valuing the securities, if he has inspected the underlying documentation, and if he believes the procedures are reasonable and documentation appropriate.

Separate Report on Supplementary Schedules

It is also acceptable to present a separate auditor's report on the supplementary schedules as follows:

Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 of the Securities and Exchange Commission

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries as of and for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied

in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

**New York, New York
February 15, 19X2**

Exhibit B

STANDARD STOCKBROKERAGE CO., INC. AND SUBSIDIARIES

Consolidated Statement of Financial Condition

December 31, 19X1

ASSETS

Cash	\$ 2,647,472
Cash and securities segregated under federal and other regulations (Note 3)	1,005,000
Deposits with clearing organizations and others (Cash \$345,000 and securities with a market value of \$1,400,000)	1,745,000
Receivable from brokers and dealers	25,476,250
Receivable from customers (Note 4) ¹⁰	40,360,723
Securities purchased under agreements to resell	6,282,498
Securities owned (Note 5)	
Marketable, at market value	20,738,387
Not readily marketable, at estimated fair value	10,730,685
Spot commodities owned, at market value	3,278,000
Secured demand notes collateralized by marketable securities	5,215,000
Memberships in exchanges	
Owned, at cost less \$825,000 valuation allowance (market value \$2,000,000)	2,100,000
Contributed for the use of the Company, at market value	375,000
Furniture, equipment, and leasehold improvements, at cost, less accumulated depreciation and amortization of \$2,425,249 (Note 9)	4,881,769
Other assets	723,459
	<u>\$125,559,243</u>

The accompanying notes are an integral part of these financial statements.

¹⁰ Valuation reserves should be shown parenthetically or in a note if material.

LIABILITIES AND STOCKHOLDERS' EQUITY

Short-term bank loans (Note 6)	\$ 23,000,000
Drafts payable	3,902,000
Payable to brokers and dealers	12,015,622
Payable to clearing broker (Note 7)	9,359,621
Payable to customers (Note 4)	12,288,629
Securities sold under agreements to repurchase (Note 8)	5,780,498
Securities sold, but not yet purchased, at market value (Note 5)	1,862,729
Income taxes, including deferred taxes of \$1,200,000	2,276,473
Accounts payable, accrued expenses, and other liabilities	2,449,499
Long-term notes payable (Note 9)	3,000,000
	<u>75,935,071</u>
Commitments and contingent liabilities (Note 13)	
Liabilities subordinated to claims of general creditors (Note 10)	<u>9,897,000</u>
Stockholders' equity (Notes 11 and 14) ¹¹	
Preferred stock	5,000,000
Common stock	6,289,000
Additional paid-in capital	2,200,000
Retained earnings	27,438,172
Less common stock in treasury, at cost	(1,200,000)
Total stockholders' equity ¹²	<u>39,727,172</u>
	<u><u>\$125,559,243</u></u>

¹¹ As discussed in paragraph 2.15, "Statement of Financial Condition", it is permissible to present a combination of subordinated liabilities and stockholders' equity. An acceptable presentation is illustrated below.

Subordinated liabilities and stockholders' equity
Liabilities subordinated to claims of general creditors
(Note 10)

9,897,000

Stockholders' equity (Notes 11 and 14)

Preferred stock	\$5,000,000
Common stock	6,289,000
Additional paid-in capital	2,200,000
Retained earnings	27,438,172
Less common stock in treasury at cost:	<u>(1,200,000)</u>

Total stockholders' equity

39,727,172

Total subordinated liabilities and stockholders' equity

49,624,172

¹² It is permissible, for the purpose of the separate report on the statement of financial condition (which is required to be distributed to customers) to present only the total of stockholders' equity without disclosure of the various components.

Exhibit C

STANDARD STOCKBROKERAGE CO., INC. AND SUBSIDIARIES

Consolidated Statement of Income

For the Year Ended December 31, 19X1

Revenues	
Commissions	\$40,980,211
Net dealer inventory and investment gains (losses) ¹³	1,606,778
Investment banking	1,789,000
Interest and dividends	1,242,823
Other	400,000
	<u>46,018,812</u>
Expenses	
Employee compensation and benefits	17,289,128
Commissions and floor brokerage	4,128,491
Communications	4,826,000
Occupancy and equipment rental	1,625,000
Interest	896,482
Taxes, other than income taxes	127,777
Other operating expenses	3,421,001
	<u>32,313,879</u>
Income before income taxes	13,704,933
Income taxes, including deferred taxes of \$425,000 (Note 15)	7,100,000
Net income	<u>\$ 6,604,933</u>
Earnings per share of common stock (Note 16)	<u>\$ 4.88 ¹⁴</u>

The accompanying notes are an integral part of these financial statements.

¹³ The amount of the change in unrealized gains and losses attributable to investment securities that are not readily marketable and that have been valued at fair value by the Board of Directors should be disclosed, if material.

¹⁴ Not required to be presented by nonpublic enterprises defined by FASB Statement No. 21, *Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises*.

Exhibit D

**STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES**
Consolidated Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 19X1

	<u>Capital Stock</u>		<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>
	<u>Preferred</u>	<u>Common</u>			
Balances at January 1, 19X1	\$5,250,000	\$6,289,000	\$2,212,500	\$21,083,239	(\$1,098,000)
Net income				6,604,933	
Retirement of 2,500 preferred shares	(250,000)				
Dividend on preferred stock, \$5 a share			(12,500)		
Repurchase of 6,000 common shares for treasury				(250,000)	
Sale of 2,600 common shares from treasury upon exercise of options					(180,000)
					78,000
Balances at December 31, 19X1	<u>\$5,000,000</u>	<u>\$6,289,000</u>	<u>\$2,200,000</u>	<u>\$27,438,172</u>	<u>(\$1,200,000)</u>

The accompanying notes are an integral part of these financial statements.

Exhibit E

STANDARD STOCKBROKERAGE CO., INC. AND SUBSIDIARIES**Consolidated Statement of Changes in Liabilities****Subordinated to Claims and General Creditors****For the Year Ended December 31, 19X1**

Subordinated liabilities at January 1, 19X1	\$4,204,000
Increases	
Liability pursuant to secured demand note	
collateral agreements	3,325,000
Issuance of subordinated notes	5,675,000
Decreases	
Payment of subordinated notes	(3,307,000)
Subordinated liabilities at December 31, 19X1	<u>\$9,897,000</u>

The accompanying notes are an integral part of these financial statements.

Exhibit F

STANDARD STOCKBROKERAGE CO., INC. AND SUBSIDIARIES**Consolidated Statement of Changes in Financial Position***
For the Year Ended December 31, 19X1

Funds provided by	
Operations	
Net income	\$ 6,604,933
Items not affecting funds	
Depreciation and amortization	582,371
Write-down of exchange memberships	400,000
Deferred income taxes	425,000
Total from operations	8,012,304
Increase in	
Payable to clearing broker	2,427,541
Securities sold under agreements to repurchase	587,313
Decrease in	
Net receivable from brokers and dealers	2,309,316
Securities purchased under agreements to resell	2,348,518
Securities owned, net	4,655,123
Cash and deposits with clearing organizations and others	1,220,742
Common stock issued from treasury	78,000
Issuance of secured demand note collateral agreements	3,325,000
Issuance of subordinated notes	5,675,000
	<u>\$30,638,857</u>
Funds applied to	
Increase in	
Net receivable from customers	\$10,801,317
Spot commodities owned	2,314,128
Decrease in	
Short-term bank loans	7,662,496
Drafts payable	1,329,652
Secured demand notes receivable	3,325,000
Payments of long-term notes payable	500,000
Repayment of subordinated notes	3,307,000
Retirement of preferred stock	262,500
Purchase of common stock for treasury	180,000
Dividend on preferred stock	250,000
Other, net	706,764
	<u>\$30,638,857</u>

The accompanying notes are an integral part of these financial statements.

* [Note—FASB Statement No. 95, *Statement of Cash Flows*, as amended, supersedes APB Opinion 19, *Reporting Changes in Financial Position*, and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position. A statement of cash flows will be illustrated in future editions.]

Exhibit G

STANDARD STOCKBROKERAGE CO., INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements****For the Year Ended December 31, 19X1**

(The following notes to financial statements are illustrative only. In some situations the information in notes may be better presented within the financial statements; in other situations information not required by regulation may not be sufficiently material to warrant disclosure.)

In addition to the disclosures shown, there may be certain other disclosures required under Regulation S-X of the Securities and Exchange Commission for those companies that are registered under section 12(b) or 12(g) of the Securities Exchange Act of 1934. Regulation S-X does not apply to the financial statements filed with the SEC under rule 17a-5, except for the independence requirements of Regulation S-X, which do apply.)

1. Significant Accounting Policies

The consolidated financial statements include the accounts of the Company, all wholly owned subsidiaries, and a subsidiary that is 80 percent owned. Such subsidiaries are engaged primarily in brokerage, investment advisory, and venture capital business. All material intercompany balances and transactions are eliminated in consolidation.

Customers' securities and commodities transactions are recorded on a settlement date basis with related commission income and expenses recorded on a trade date basis.¹⁵ Securities and commodities transactions of the Company are recorded on a trade date basis. Investment banking revenue is recorded as follows: ¹⁶ management fees on offering date, sales concessions on settlement date, and underwriting fees at the time the underwriting is completed and the income is reasonably determinable.

Marketable securities are valued at market value and securities not readily marketable are valued at fair value as determined by the Board of Directors. The resulting difference between cost and market (or fair value) is included in income.

Repurchase and resale agreements are treated as financing transactions and are carried at the amounts at which the securities will be subsequently reacquired or resold as specified in the respective agreements.

Deferred income taxes are provided when income and expenses, principally relating to the valuation of trading and investment securities, are recognized in different years for financial and tax reporting purposes. Investment tax credits are accounted for on the flow-through method, under which the benefit is reflected as a reduction of the tax provision in the year related assets are placed in service.

Depreciation is provided on a straight-line basis using estimated useful lives of ten to fifteen years. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

Exchange memberships are carried at cost less an allowance of \$825,000, which represents management's estimate of the permanent impairment of value of certain memberships.

¹⁵ See chapter 1 of this guide regarding settlement date versus trade date basis accounting.

¹⁶ Illustrative disclosure, not necessarily required.

2. Consolidated Subsidiaries ¹⁷

The following is a summary of certain financial information of the Company's consolidated subsidiaries.

	<i>Broker Dealer (100% owned)</i>	<i>Investment Advisory (100% owned)</i>	<i>Venture Capital (80% owned)</i>	<i>Total</i>
	<i>(Amounts in Thousands)</i>			
Total assets	\$12,700	\$1,700	\$5,100	\$19,500
Stockholders' equity	\$ 2,800	\$ 400	\$1,800	\$ 5,000

The \$2,800,000 of stockholders' equity and \$1,500,000 of subordinated liabilities of the broker-dealer subsidiary are included as capital in a consolidated computation of the Company's net capital since the assets of the subsidiary are readily available for the protection of the company's customers, broker-dealers, and other creditors, as permitted by rule 15c3-1. The accounts of the other subsidiaries are not included in the computation.

3. Cash and Securities Segregated Under Federal and Other Regulations

Cash of \$275,000 and U.S. Treasury bills with a market value of \$630,000 are segregated under the Commodity Exchange Act and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Cash of \$100,000 has been segregated in a special reserve bank account for the benefit of customers under rule 15c3-3 of the Securities and Exchange Commission.¹⁸

4. Receivable From and Payable to Customers

Accounts receivable from and payable to customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for receivables. Such collateral is not reflected in the financial statements.

5. Securities Owned and Sold but Not Yet Purchased

Marketable securities owned and sold but not yet purchased consist of trading and investment securities at quoted market values, as illustrated below.

	<i>Owned</i>	<i>Sold But Not Yet Purchased</i>
Obligations of U.S. government	\$ 400,000	
State and municipal obligations	608,060	
Corporate bonds, debentures, and notes	6,900,000	
Corporate stocks	11,930,327	\$1,190,415
Options and warrants	900,000	672,314
	<u>\$20,738,387</u>	<u>\$1,862,729</u>

¹⁷ Information in this note is presented principally to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of flow-through capital of broker-dealer subsidiary). If the company and its subsidiaries are engaged in unrelated business that could be considered separate business segments, it may be necessary for public companies to disclose financial information of the separate business segments as required by FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*.

¹⁸ This is possible wording in those situations where a deposit is required based on rule 15c3-3 computation.

Securities not readily marketable include investment securities (a) for which there is no market on a securities exchange or no independent publicly quoted market, (b) that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933, or (c) that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the company.

6. Bank Loans

Short-term bank loans bear interest at a fluctuating rate based on prime (average rate of 9.1 percent at December 31, 19X1). The loans are fully collateralized by marketable securities valued at \$38,000,000. Such collateral includes \$26,500,000 of customers' margin account securities, \$8,500,000 of securities owned by the Company, and \$3,000,000 of securities held pursuant to secured demand note collateral agreements.

The Company is contingently liable as of December 31, 19X1, in the amount of \$4,375,000 under bank guarantees and has outstanding letter of credit agreements used in lieu of margin deposits. These agreements are generally made for periods of six months to one year and bear interest at rates from .5 percent to 1 percent.

7. Payable to Clearing Broker

The payable to clearing broker is for customers' transactions and is collateralized by customers' securities. Interest is at a fluctuating rate (9 percent at December 31, 19X1) that generally corresponds to the broker call money rate.

8. Securities Sold Under Agreements to Repurchase

At December 31, 19X1, the market value of the securities sold subject to repurchase was \$5,790,000 and the average effective interest rate at that date on the transactions was 8.5 percent.

9. Long-Term Notes Payable

The notes payable bear interest at 7.5 percent and are payable in semiannual installments of \$250,000 through July 1, 19X7. Furniture and equipment with a net carrying value of \$2,500,000 has been pledged to secure the notes.

10. Liabilities Subordinated to Claims of General Creditors¹⁹

The borrowings under subordination agreements at December 31, 19X1, are listed below.

Subordinated notes, 10%, due December 31, 19X3	\$4,682,000
Liabilities pursuant to secured demand note collateral agreements, 6%, due \$1,000,000 in March 19X2, \$1,200,000 in March 19X3, and \$3,015,000 in December 19X3	5,215,000
	<u>\$9,897,000</u>

The subordinated borrowings are covered by agreements approved by the New York Stock Exchange, Inc. (or other regulatory organizations) and are thus available in computing net capital under the Securities and Exchange Commission's uniform net capital rule. To the extent that such borrowings are required for the Company's continued compliance with minimum net capital requirements, they may not be repaid (Note 14).²⁰

¹⁹ Significant restrictive covenants of debt agreements should be disclosed.

²⁰ Due to the unique characteristics of subordinated borrowings, additional disclosure is necessary of the amount for which six months' notice has been given of intent to withdraw.

11. *Capital Stock*

The authorized, issued, and outstanding shares of capital stock at December 31, 19X1, were as follows:

Preferred stock, \$5 cumulative, \$100 par value, redeemable at \$105 a share; authorized 100,000 shares; issued and outstanding 50,000 shares

Common stock, without par value; authorized 2,500,000 shares; issued 1,500,000 shares (in treasury 199,100 shares)

In 19X1 stockholders approved adoption of a qualified stock option plan covering 100,000 shares of common stock. Options may be granted during the period to June 19X7 at 100 percent of the market value at the date of grant and are exercisable within five years from date of grant. During 19X1 options for 40,000 shares were granted at \$30 a share, and options for 2,600 shares were exercised.

12. *Pension Plans*

[Deleted—See FASB Statement No. 87, *Employers' Accounting for Pensions*, for current disclosure requirements.]

13. *Commitments and Contingent Liabilities*

Under operating leases with remaining noncancellable terms in excess of one year at December 31, 19X1, aggregate annual rentals for office space and equipment are approximately as listed below.

19X2	\$1,492,000
19X3	1,440,000
19X4	1,006,000
19X5	982,000
19X6	901,000
Later years	1,164,000
	<u>\$6,985,000</u>

The Company and a subsidiary, together with various other brokers and dealers, corporations, and individuals, have been named as defendants in several class action lawsuits that allege violations of federal and state securities laws and claim substantial damages. The Company is also a defendant in other lawsuits incidental to its securities and commodities business. Management of the Company, after consultation with outside legal counsel, believes that the resolution of these various lawsuits will not result in any material adverse effect on the Company's consolidated financial position.

In the normal course of business, the Company enters into underwriting commitments. Transactions relating to such underwriting commitments that were open at December 31, 19X1, and were subsequently settled had no material effect on the financial statements as of that date.

The Company also engages in purchase, sale, and future contract transactions involving GNMA securities.

14. *Net Capital Requirements*²¹

The Company is subject to the Securities and Exchange Commission Uniform Net Capital Rule (rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1 (and the rule of the

²¹ If the broker or dealer is a futures commission merchant subject to regulation 1.17 of the Commodity Futures Trading Commission, a comparable disclosure should be made of minimum net capital required by that regulation.

"applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1.²² At December 31, 19X1, the Company had net capital of \$23,784,221, which was \$20,009,112 in excess of its required net capital of \$3,775,109. The Company's net capital ratio was 2.4 to 1.²³

15. *Income Taxes*

NOTE: See FASB Statement No. 109, *Accounting for Income Taxes*, for disclosure requirements that are effective for fiscal years beginning after December 15, 1992.

The income tax provision consists of the following:

Federal	\$5,300,000
State and local	<u>1,800,000</u>
	<u>\$7,100,000</u>

Deferred income taxes are principally applicable to unrealized appreciation of securities.

A reconciliation of the federal income tax ordinary rate of 46 percent with the actual effective rate provided is illustrated below.²⁴

²² Various regulatory agencies and exchanges may impose additional capital requirements, that may be necessary to disclose.

²³ If the company has elected to compute net capital under the alternative method of rule 15c3-1, appropriate wording would be as follows:

The Company is subject to the Securities and Exchange Commission's Uniform Net Capital Rule (rule 15c3-1), which requires the maintenance of minimum net capital. The Company has elected to use the alternative method, permitted by the rule, which requires that the Company and its subsidiary maintain minimum net capital, as defined, equal to the greater of \$100,000 each or 2 percent of aggregate debit balances arising from customer transactions, as defined. (The net capital rule of the "applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if resulting net capital would be less than 5 percent of aggregate debits.) At December 31, 19X1, the Company had net capital of \$25,125,221, which was 46.6 percent of aggregate debit balances and \$23,885,645 in excess of required net capital.

²⁴ Generally, optional disclosure for firms not subject to SEC Regulation S-X. An explanation of a disproportionate tax provision, however, is required under generally accepted accounting principles.

Ordinary federal income tax rate	46.0%
Increases (reductions) resulting from	
Tax exempt interest	(1.5)
Dividend deduction	(1.9)
State and local income taxes, net of federal tax benefit	7.1
Investment tax credits in the amount of \$33,500	(0.2)
Other	<u>2.3</u>
Income tax rate incurred	<u>51.8%</u>

16. *Earnings Per Share*

Earnings per share of common stock was computed by dividing net income, less the preferred stock dividend requirement, by the weighted average number of common shares outstanding for the year (1,302,000 shares). Outstanding stock options were not dilutive.

Exhibit H

Supplementary Information
Pursuant to Rule 17a-5 of the
Securities Exchange Act of 1934
As of December 31, 19X1

(The accompanying schedules are prepared in accordance with the requirements and general format of FOCUS Form X-17A-5. If desired, the preprinted FOCUS forms may be used for presenting the required supplementary information. The auditor should be aware of certain exemptive provisions under SEC rule 15c3-3 regarding the computation of net capital (Schedule I) and the computation for the determination of reserve requirements (Schedule II). If the exemptive provisions apply, a note should be added by the broker or dealer to the schedules stating that the broker or dealer was in compliance with the conditions of exemption.)

Schedule I

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

NET CAPITAL	
Total consolidated stockholders' equity	\$39,727,172
Deduct stockholders' equity not allowable for net capital	2,200,000
Total stockholders' equity qualified for net capital	<u>37,527,172</u>
Add:	
A. Liabilities subordinated to claims of general creditors allowable in computation of net capital	9,897,000
B. Other (deductions) or allowable credits—deferred income taxes payable	1,200,000
Total capital and allowable subordinated liabilities	<u>48,624,172</u>
Deductions and/or charges	
A. Non-allowable assets	
Securities not readily marketable	\$10,730,685
Exchange memberships	2,100,000
Furniture, equipment, and leasehold improvements	2,381,769
Other assets	<u>472,381</u>
	15,684,835
	(continued)

Schedule I (cont.)

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

1. Additional charges for customers' and non-customers' security accounts	820,634	
2. Additional charges for customers' and non-customers' commodity accounts	78,450	
B. Aged fails-to-deliver	42,367	
1. Number of items—52	44,870	
C. Aged short security differences	525,000	
1. Number of items—6		
D. Secured demand note deficiency	163,900	17,882,666
E. Commodity futures contracts and spot commodities—proprietary capital charges	522,610	30,741,506
F. Other deductions and/or charges		
Net capital before haircuts on securities positions		
Haircuts on securities (computed, where applicable, pursuant to rule 15c3-1(f))	2,520,000	
A. Contractual securities commitments	828,000	
B. Deficit in securities collateralizing secured demand notes		
C. Trading and investment securities		
1. Bankers' acceptances, certificates of deposit, and commercial paper	34,800	
2. U.S. and Canadian government obligations	27,300	
3. State and municipal government obligations	14,200	
4. Corporate obligations	184,000	
5. Stocks and warrants	2,682,000	
6. Options	212,000	
7. Other securities	53,400	
D. Undue concentrations	87,315	6,957,285
E. Other	314,270	
Net capital		\$23,784,221

AGGREGATE INDEBTEDNESS

Items included in consolidated statement of financial condition ²⁵

Short-term bank loans (secured by customers' securities)

Drafts payable

Payable to brokers and dealers

Payable to clearing broker

Payable to customers

Other accounts payable and accrued expenses

Items not included in consolidated statement of financial condition

Market value of securities borrowed for which no equivalent value is paid or credited

Other unrecorded amounts

\$14,500,000
3,902,000
8,101,412
9,359,621
11,716,031
3,150,972

4,742,000
1,154,598
56,626,634

Less adjustment based on special reverse bank accounts

—

Total aggregate indebtedness

\$56,626,634
(continued)

²⁵ Excludes balances of consolidated subsidiaries other than wholly owned broker-dealer subsidiaries included in consolidated computation of net capital.

Schedule I (cont.)

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

COMPUTATION OF BASIC NET CAPITAL REQUIREMENT

Minimum net capital required	
Company	\$ 3,346,836
Broker-dealer subsidiary	428,273
Total	<u>\$ 3,775,109</u>
Excess net capital at 1500%	<u>\$20,009,112</u>
Excess net capital at 1000%	<u>\$18,121,558</u>
Ratio: Aggregate indebtedness to net capital	<u>2.38 to 1</u>

RECONCILIATION WITH COMPANY'S COMPUTATION ²⁶ (included

in Part II of Form X-17A-5 as of December 31, 19X1)	
Net capital, as reported in Company's Part II (Unaudited)	
FOCUS report	\$24,153,197
Allowable assets erroneously reported as non-allowable	
Deposits	582,641
Accrued interest receivable	378,420
Difference due to offsetting various asset accounts against related liabilities	(2,518,490)
Net audit adjustments	873,253
Other items, net	315,200
Net capital per above	<u>\$23,784,221</u>

²⁶ If there is no material difference from the company's computation and a reconciliation is not included, a statement to that effect is required.

COMPUTATION OF ALTERNATE NET CAPITAL REQUIREMENT ²⁷

2% of aggregate debit items (or \$100,000 if greater) as shown in formula for reserve requirements pursuant to rule 15c3-3 prepared as of date of net capital computation — Company
 Capital requirement of consolidated broker-dealer subsidiary electing alternative method

\$ 1,077,235
162,341
<u>\$ 1,239,576</u>
<u>\$23,885,645</u>
<u>\$22,026,281</u>
<u>\$21,406,496</u>

Total net capital requirement

Excess net capital ²⁸

Net capital in excess of

4% of aggregate debit items

5% of aggregate debit items

²⁷ To be included if the company has elected to use the alternate method of computing net capital pursuant to Appendix C of rule 15c3-1.

²⁸ Net capital under the alternative method is computed on a basis similar to the basic net capital computation but using generally lesser percentage security haircuts. In the "Net Capital" section of this schedule, net capital would have been \$25,125,221 under the alternative computation.

Schedule II

STANDARD STOCKBROKERAGE CO., INC.

Computation for Determination of Reserve Requirements

Under Rule 15c3-3 of the Securities and Exchange Commission

(Parent company only)

As of December 31, 19X1

CREDIT BALANCES:

Free credit balances and other credit balances in customers' security accounts (including non-regulated commodity accounts, net of related margin deposits of \$322,300)

Monies borrowed collateralized by securities carried for the accounts of customers

Monies payable against customers' securities loaned

Customers' securities failed to receive (including credit balances in continuous net settlement accounts)

Credit balances in firm accounts which are attributable to principal sales to customers

Market value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days

Market value of short security count differences over 30 calendar days old ²⁹

Market value of short securities and credits (not to be offset by "longs" or by debits) in all suspense accounts over 30 calendar days ³⁰

Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days

Total credit items

\$10,716,031
18,402,000
1,825,000
6,276,412
1,238,376
327,841
5,917
78,118
38,953
<u>38,908,648</u>

²⁹ Would be seven calendar days if the broker or dealer had elected the alternative net capital requirement under rule 15c3-1(f).

³⁰ See footnote 29.

DEBIT BALANCES

Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to rule 15c3-3
 Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver
 Failed to deliver of customers' securities not older than 30 calendar days (including debit balances in continuous net settlement accounts)
 Other

37,322,458

1,318,216

14,782,362

438,715

53,861,751**Total debit items****RESERVE COMPUTATION ³¹**

Excess of total debits over total credits

\$14,953,103

Required deposit

None

RECONCILIATION with Company's computation ³² (included in Part II of Form X-17A-5 as of December 31, 19X1)
 Excess as reported in Company's Part II

FOCUS report

Non-regulated commodity margin deposits erroneously

excluded from the Company's report

Other items, net

\$15,492,744

\$322,300217,341

Excess per this computation

(539,641)

\$14,953,103

³¹ Those firms calculating net capital under the alternative method are required to reduce this amount by 3 percent.

³² If there is no material difference from the company's computation and a reconciliation is not included, a statement to that effect is required.

Schedule III

STANDARD STOCKBROKERAGE CO., INC.

Information Relating to Possession or Control Requirements Under
Rule 15c3-3 of the Securities and Exchange Commission

(Parent company only)

As of December 31, 19X1

1. Customers' fully paid securities and excess margin securities not in the respondent's possession or control as of the report date (for which instructions to reduce to possession or control had been issued as of the report date) but for which the required action was not taken by respondent within the time frames specified under rule 15c3-3.³³ \$18,200

A. Number of items 2

2. Customers' fully paid securities and excess margin securities for which instructions to reduce to possession or control had not been issued as of the report date, excluding items arising from "temporary lags which result from normal business operations" as permitted under rule 15c3-3.³⁴ \$39,000

A. Number of items 5

³³ If customers' fully paid securities are subsequently reduced to possession or control, a statement to that effect could be included.

³⁴ In some instances it may be impractical to determine the number of items in response to item 2. Also, it may be impractical to determine whether the company has subsequently issued instructions to reduce those items to possession or control or to determine that such instructions were acted upon.

Schedule IV

STANDARD STOCKBROKERAGE CO., INC.

Schedule of Segregation Requirements and Funds in Segregation for
Customers' Regulated Commodity Futures and Options Accounts

As of December 31, 19X1

SEGREGATION REQUIREMENTS

1. Net ledger balance:	
a. Cash	\$ 976,700
b. Securities (at market)	784,800
2. Net unrealized profit (loss) in open futures contracts	(367,800)
3. Exchange traded options:	
a. Add: market value of open option contracts purchased on a contract market	143,600
b. Deduct: market value of open option contracts granted (sold) on a contract market	(129,800)
4. Net equity (deficit) (Total of 1, 2, and 3)	1,407,500
5. Add: accounts liquidating to a deficit and accounts with debit balances with no open trades	78,450
6. Amount required to be segregated (Total of 4 & 5)	1,485,950

FUNDS ON DEPOSIT IN SEGREGATION

7. Deposited in segregated funds bank accounts:	
a. Cash	204,200
b. Securities representing investments of customers' funds (at market)	140,300
c. Securities held for customers in lieu of cash margins (at market)	784,800
8. Margins on deposit with clearing organizations of contract markets:	
a. Cash	170,800
b. Securities representing investments of customers' funds (at market)	489,700
c. Securities held for customers in lieu of cash margins (at market)	—
9. Settlement due from (to) contract market clearing organization	(28,500)
10. Exchange traded options:	
a. Add: unrealized receivables for option contracts purchased on contract markets	74,300
b. Deduct: unrealized obligations for option contracts granted (sold) on contract markets	(81,200)
11. Net equities with other FCMs	(37,200)
12. Segregated funds on hand:	
a. Cash	—
b. Securities representing investments of customers' funds (at market)	—
c. Securities held for customers in lieu of cash margins (at market)	—
13. Total amount in segregation (Total of 7 through 12)	1,717,200
14. Excess funds (Insufficiency) in segregation (13 minus 6)	\$ 231,250

Exhibit I

**Independent Auditor's Report on Internal Control Structure Required
by SEC Rule 17a-5****Board of Directors****Standard Stockbrokerage Co., Inc.**

In planning and performing our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission, we have made a study of the practices and procedures³⁵ (including tests of compliance with such practices and procedures) followed by Standard Stockbrokerage Co., Inc. that we considered relevant to the objectives stated in rule 17a-5(g), (1) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e); (2) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by rule 17a-13;³⁶ (3) in complying with the requirements for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System; and (4) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

The management of the Company is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the

³⁵ If the broker or dealer is exempt from compliance with rule 15c3-3, certain references to this rule (item 4 of the second paragraph) should be omitted. In addition, item (1) of the second paragraph should be revised as follows: "in making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the procedures for determining compliance with the exemptive provisions of rule 15c3-3." The independent auditor should include a statement indicating that the broker or dealer was in compliance with the conditions of the exemption and that no facts came to the attention of the independent auditor indicating that such conditions had not been complied with during the period.

³⁶ If the broker or dealer does not maintain customer accounts and does not handle securities, he may not be required to have any of the procedures described in items (2), (3), or (4) of this paragraph. In this instance it would be appropriate to indicate the procedures that have been reviewed and separately indicate those that have not been reviewed and the reason they were excluded. If the broker or dealer has occasional receipts of securities, even if such securities are immediately transmitted to a clearing organization or custodian, the report should retain the reference to the review of procedures for safeguarding securities since the broker or dealer is required to, and usually will, have such procedures. In some instances a statement that the broker or dealer does not handle securities and accordingly has not established such procedures will be appropriate.

The following is an example of this paragraph of the report under these conditions.

We also made a study of the practices and procedures followed by the Company in making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the procedures for determining compliance with the exemptive provisions of rule 15c3-3. We did not review the practices and procedures followed by the Company in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by rule 17a-13 or in complying with the requirements for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System, because the Company does not carry security accounts for customers or perform custodial functions relating to customer securities.

practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above.³⁷

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.³⁸

³⁷ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control procedures, or procedures for safeguarding securities] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.]

³⁸ Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the footnote above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the SEC.

This report is intended solely for the use of management, the Securities and Exchange Commission, the New York Stock Exchange and other regulatory agencies which rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 and should not be used for any other purpose.

Accounting Firm
New York, New York
February 15, 19X2

Exhibit J

Independent Auditor's Report on Internal Control Structure Required by SEC Rule 17a-5

(The following report is appropriate when the broker or dealer has not made the required notification or when the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.)

December 10, 19X1

Securities and Exchange Commission
Washington D.C. and Appropriate
Regional Office
Designated Examining Authority

Dear Sirs:

Our most recent audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries was as of December 31, 19X0, and for the year then ended, which we reported on under date of February 15, 19X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 19X0. Although we are presently performing certain procedures as part of our audit of the consolidated financial statements of the Company as of December 31, 19X1, and for the year then ended, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with generally accepted auditing standards or all procedures necessary to (1) consider the Company's internal control structure as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of Standard Stockbrokerage Co., Inc. is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily disclose all material weaknesses in the internal control structure, including procedures for safeguarding securities.

AAG-BRD APP A

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc. and we believe the following additional information is required pursuant to the requirements of rule 17a-11(f).

[List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.]

Accounting Firm

New York, New York

Exhibit K**Independent Auditor's Report on Internal Control Structure Required by Regulation 1.16 of the Commodity Futures Trading Commission****Board of Directors****ABC Commodities Corporation**

In planning and performing our audit of the consolidated financial statements of ABC Commodities Corporation (the "Corporation") for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by the Corporation that we considered relevant to the objectives stated in the Regulation 1.16 in making (1) the periodic computations of minimum financial requirements pursuant to Regulation 1.17, (2) the daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations, and (3) the daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the Commission.

The management of the Corporation is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Corporation has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Regulation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that

would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.³⁹

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Corporation's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.⁴⁰

This report is intended solely for the use of management, the Commodity Futures Trading Commission, and other regulatory agencies that rely on Regulation 1.16 of the Commodity Futures Trading Commission and should not be used for any other purpose.

Accounting Firm

New York, New York
February 15, 19X2

³⁹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [(control environment, accounting system, control procedures, or procedures for safeguarding customer and firm assets)] and its [(their)] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of the Corporation for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [*A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.*]

⁴⁰ Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the CFTC.

Exhibit L**Independent Auditor's Report on the SIPC Annual Assessment
Required by SEC Rule 17a-5**

**Board of Directors
Standard Stockbrokerage Co., Inc.**

In accordance with rule 17a-5(e)(4) of the Securities and Exchange Commission, we have performed the following procedures with respect to the accompanying schedule (Form SIPC-7) of Securities Investor Protection Corporation assessments and payments of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1. Our procedures were performed solely to assist you in complying with rule 17a-5(e)(4), and our report is not to be used for any other purpose. The procedures we performed are as follows:

1. Compared listed assessment payments with respective cash disbursement records entries;
2. Compared amounts reported on the audited Form X-17A-5 for the period January 1, 19X1, to December 31, 19X1, with the amounts reported in the General Assessment Reconciliation (Form SIPC-7);
3. Compared any adjustments reported in Form SIPC-7 with supporting schedules and working papers;
4. Proved the arithmetical accuracy of the calculations reflected in Form SIPC-7 and in the related schedules and working papers supporting adjustments; and
5. Compared the amount of any overpayment applied with the Form SIPC-7 on which it was computed.

Because the above procedures do not constitute an audit made in accordance with generally accepted auditing standards, we do not express an opinion on the schedule referred to above. In connection with the procedures referred to above, nothing came to our attention that caused us to believe that the amounts shown on Form SIPC-7 were not determined in accordance with applicable instructions and forms. This report relates only to the schedule referred to above and does not extend to any financial statements of Standard Stockbrokerage Co., Inc. taken as a whole.

Accounting Firm

**New York, New York
February 15, 19X2**

Exhibit M

Representation Letter

February 15, 19X2

Accounting Firm

Gentlemen:

In connection with your audit of the consolidated statement of financial condition as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and for the year then ended, for the purpose of expressing an opinion as to whether the consolidated financial statements present fairly the financial position, results of operations, and cash flows of Standard Stockbrokerage Co., Inc. and Subsidiaries in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.⁴¹

1. We are responsible for the fair presentation in the consolidated financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.
2. We have made available to you all—
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no—
 - a. Irregularities involving management or employees who have significant roles in the internal control structure policies and procedures.
 - b. Irregularities involving other employees that could have a material effect on the consolidated financial statements.
 - c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices or record-keeping that could have a material effect on the consolidated financial statements.
4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
5. The following have been properly recorded or disclosed in the consolidated financial statements:
 - a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

⁴¹ As provided in paragraph 5 of SAS No. 19, *Client Representations*, a paragraph might be added to state that management's representations pertain to items that exceed, individually or collectively, a stated materiality limit. Such a paragraph should indicate that the limitation does not apply to items 1, 2, 3a, and 3b.

- b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
 - c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.
 - d. Agreements to repurchase assets previously sold.
6. There are no—
- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.
7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.
8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
9. Customers' debit balances, brokers' debit balances, and other accounts receivable are valid receivables. In our opinion, an adequate reserve has been established to cover any losses that may be incurred upon collection.
10. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged except as disclosed in the consolidated financial statements or the notes thereto.
11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any purchase or sales commitments.
12. There are no securities or investments not readily marketable owned by the Company or borrowed under subordination agreements except as disclosed in the consolidated financial statements or notes thereto (or as follows):
- It is understood that the term "securities and investments not readily marketable" shall include, but not be limited to, (a) securities for which there is no market on a securities exchange or independent publicly quoted market, (b) securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A, under section 3(B) of such act have been complied with) that is, restricted stock, or (c) securities and investments that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities and investments or to the Company (that is, control stock).
13. In addition, the Company at December 31, 19X1, had—
- a. All securities exchange memberships recorded on the books.

- b. All participation in joint accounts carried by others properly recorded.
 - c. No material unrecorded assets or contingent assets (such as claims relating to buy-ins, unfulfilled contracts, and so forth, whose value depends on fulfillment of conditions regarded as uncertain).
 - d. No open contractual commitments other than those appearing on the memo books and records (for example, when-distributed and delayed delivery contracts, underwritings and when-issued contracts, endorsements or puts and calls, and commitments in foreign currencies and spot [cash] commodity contracts).
 - e. Established a reserve for dividends and transfer items and security differences that is adequate to cover any anticipated losses in connection with the short securities that may have to be covered or claims arising from the liquidation of long securities.
 - f. No borrowings or claims that were unconditionally subordinated to all claims or general creditors pursuant to a written agreement except as disclosed in the financial statements or notes thereto.
14. All liabilities subordinated to the claims of general creditors are covered by satisfactory subordination agreements under rule 15c3-1 and approved by [*examining authority*].
 15. We have complied with all aspects of contractual agreements that would have a material effect on the consolidated financial statements in the event of noncompliance.
 16. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the consolidated financial statements.
 17. There are no capital withdrawals anticipated within the next six months other than as disclosed in the consolidated financial statements or notes thereto.
 18. There are no material inadequacies at December 31, 19X1, or during the period January 1, 19X1, to February 15, 19X2, in the accounting system, the internal accounting controls, the procedures for safeguarding securities, and the practices and procedures followed—
 - a. In making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e).
 - b. In making the quarterly securities examinations, counts, verifications and comparisons and the reconciliation of differences required by rule 17a-13.
 - c. In complying with the requirement for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System.
 - d. In obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

- e. In making periodic computations of the minimum financial requirements pursuant to regulation 1.17 of the Commodity Exchange Act.
 - f. In making daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based upon such computations.
19. Net capital computations, prepared by the Company during the period from January 1, 19X2, through February 15, 19X2, indicated that the Company was in compliance with the requirements of rule 15c3-1 (and applicable exchange requirements) at all times during the period. Reserve calculations under rule 15c3-3 during the period did not reveal any deposit requirements that were not made on a timely basis.
20. There was no computation of segregation requirements under the Commodity Exchange Act that indicated an insufficiency in segregation.*

Yours very truly,

STANDARD STOCKBROKERAGE CO., INC.

Chief Financial Officer

Chief Executive Officer

* Note: The above representations are illustrative and not necessarily all-inclusive. In addition, for partnerships, representations should be obtained with respect to the appropriateness of agreements providing for the inclusion of partners' individual accounts as partnership property in the financial statements and for the purpose of computing net capital.

Appendix B**Statement of
Position****89-1****Reports on
Audited Financial Statements
of Brokers and Dealers
in Securities****January 1989**

**Amendment to
AICPA Audit and Accounting Guide
*Audits of Brokers and Dealers in Securities***

**Prepared by the Stockbrokerage and Investment
Banking Committee**

**American Institute of
Certified Public Accountants**

AICPA

NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Stockbrokerage and Investment Banking Committee regarding the application of generally accepted auditing standards to reports on audited financial statements of brokers and dealers in securities. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Reports on Audited Financial Statements of Brokers and Dealers in Securities

Introduction

1. In 1985, the audit and accounting guide *Audits of Brokers and Dealers in Securities* was issued. Exhibit A of the appendix to that guide illustrates reports on audited financial statements and on supplementary schedules required by the Securities and Exchange Commission. In April 1988, the AICPA's Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, which changes the auditor's standard report on financial statements. This statement of position amends *Audits of Brokers and Dealers in Securities* in response to the changes required by SAS No. 58; the guidance in paragraphs 2 through 5 of this statement supersedes exhibit A of the guide's appendix.

Auditor's Standard Report

2. The following is an illustration of an auditor's report that expresses an unqualified opinion on the financial statements and on the supplementary schedules required by the Securities and Exchange Commission (SEC).

Independent Auditor's Report

Board of Directors

Standard Stockbrokerage Co., Inc.:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.¹

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly

¹ See the discussion of the "Financial and Operational Combined Uniform Single Report" in chapter 2 of *Audits of Brokers and Dealers in Securities* for information on obtaining confidential treatment of the financial statements from the SEC.

stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

New York, New York

February 15, 19X2

GAAP Departure—Unsupportable Valuation

3. If securities and investments that are not readily marketable are material, it will be necessary to review the procedures and underlying documentation supporting the valuations. If the auditor concludes that the valuation procedures are inadequate or unreasonable or the underlying documentation does not support the valuation, he or she may need to issue a modified opinion because of a departure from generally accepted accounting principles. Following is an example of a qualified opinion (assuming the auditor cannot reasonably determine the effects of the departure).

Independent Auditor's Report

Board of Directors

Standard Stockbrokerage Co., Inc.:

[Same first and second paragraphs as in the report illustrated in paragraph 2.]

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to \$10,730,685 (27 percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine fair value of the securities in conformity with generally accepted accounting principles. The effect of the financial statements of not applying adequate valuation procedures is not readily determinable.²

In our opinion, except for the effects on the financial statements of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.³

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects on *[identify the schedules affected]* of the valuation of investment securities determined by the Board of Directors, as described in the second preceding paragraph, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

² SEC regulations require auditors to state if they have reviewed the procedures applied by the directors in valuing the securities, if they have inspected the underlying documentation, and if they believe the procedures are reasonable and documentation appropriate.

³ In certain circumstances, depending on materiality, the qualification could apply only to the income statement.

New York, New York
February 15, 19X2

Explanatory Paragraph for Uncertainty of Valuation

4. The auditor might conclude, based on his or her review of management valuation procedures and the underlying documentation, that in the circumstances, the procedures appear to be reasonable and the documentation appropriate, but that there exists an inherent uncertainty because the range of possible values is significant. In such cases, the auditor may need to add an explanatory paragraph to the report because of the inherent uncertainty. For a further discussion of valuation of securities and investments that are not readily marketable, see the SEC's *Codification of Financial Reporting Policies*, section 404. Presented below is an example of an auditor's report in which the uncertainty is discussed in an explanatory paragraph.

Independent Auditor's Report

Board of Directors

Standard Stockbrokerage Co., Inc.:

[Same first, second, and third paragraphs as in the report illustrated in paragraph 2.]

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to \$10,730,685 (27 percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation, and in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the Board of Directors' estimate of fair values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material.

[Same paragraph reporting on supplementary schedules required by the Securities and Exchange Commission as in the report illustrated in paragraph 2.]

Accounting Firm

New York, New York
February 15, 19X2

Separate Report on Supplementary Schedules

5. It is also acceptable to present a separate auditor's report on the supplementary schedules as follows:

Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 of the Securities and Exchange Commission

Board of Directors

Standard Stockbrokerage Co., Inc.:

We have audited the accompanying consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries as of and for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is

supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm

New York, New York

February 15, 19X2

Effective Date

6. This statement is effective at the time of its issuance.

Appendix C**Statement of
Position****89-4****Reports on
the Internal Control
Structure in Audits
of Brokers and Dealers
in Securities****April 27, 1989****Amendment to
AICPA Audit and Accounting Guide
*Audits of Brokers and Dealers in Securities*****Prepared by the Stockbrokerage and Investment
Banking Committee****American Institute of
Certified Public Accountants*****AICPA***

NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Stockbrokerage and Investment Banking Committee regarding the application of generally accepted auditing standards to reports on the internal control structure in audits of brokers and dealers in securities. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities

Introduction

1. In 1985, the audit and accounting guide *Audits of Brokers and Dealers in Securities* was issued. Exhibit I of the appendix to that guide illustrates a report on internal accounting control required by Rule 17a-5 of the Securities and Exchange Commission (SEC). That illustrative report includes—

- a. A report on internal control based solely on a study and evaluation conducted as part of an audit, based on the guidance in paragraphs 47 through 53 of Statement on Auditing Standards (SAS) No. 30,* *Reporting on Internal Accounting Control*, and
- b. A report on practices and procedures specified in SEC Rule 17a-5(g)(1), based on the guidance in paragraphs 54 through 59 of SAS No. 30.*

2. In April 1988, the AICPA's Auditing Standards Board issued SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, which supersedes paragraphs 47 through 53 of SAS No. 30. Paragraphs 54 through 59 of SAS No. 30* remain in effect. This statement of position amends *Audits of Brokers and Dealers in Securities* in response to the changes required by SAS No. 60; the guidance in paragraph 3 of this statement supersedes exhibit I of the guide's appendix.¹ Also, paragraph 4 of this statement supersedes exhibit J of the guide's appendix. It should be noted that the revised report on internal control presented in paragraph 3 does not change the independent auditor's responsibilities to detect or report material inadequacies as described in SEC Rule 17a-5(g).

Reports on Internal Control Required by SEC Rule 17a-5

[3.—4.] The illustrations of the independent auditor's reports on the internal control structure required by SEC Rule 17a-5 have been incorporated into exhibits I and J of appendix A of the guide.

Effective Date

5. This statement is effective for audits of financial statements for periods beginning on or after January 1, 1989.

* SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, supersedes SAS No. 30, but does not cover reports provided pursuant to Rule 17a-5 and in Form N-SAR.

¹ SOP 90-2, *Report on the Internal Control Structure in Audits of Futures Commission Merchants*, revises exhibit K of the guide with respect to Independent Auditor's Report on Internal Control Required by Regulation 1.16 of the Commodity Futures Trading Commission.

Appendix D**Statement of
Position****90-2****Report on the
Internal Control Structure
in Audits of Futures
Commission Merchants****February 12, 1990**

**Amendment to
AICPA Audit and Accounting Guide
*Audits of Brokers and Dealers in Securities***

**Prepared by the Stockbrokerage and Investment
Banking Committee**

**American Institute of
Certified Public Accountants**

AICPA

NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Stockbrokerage and Investment Banking Committee regarding the application of generally accepted auditing standards to reporting on the internal control structure in audits of futures commission merchants. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Report on the Internal Control Structure in Audits of Futures Commission Merchants

Introduction

1. In 1985, the audit and accounting guide *Audits of Brokers and Dealers in Securities* was issued. Exhibit K of the appendix to that guide illustrates a report on internal accounting control required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC).

2. In April 1988, the AICPA's Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, which supersedes paragraphs 47 through 53 of SAS No. 30.* Paragraphs 54 through 59 of SAS No. 30* remain in effect. This statement of position amends *Audits of Brokers and Dealers in Securities* in response to the changes required by SAS No. 60; the guidance in paragraph 3 of this statement supersedes exhibit K of the guide's appendix. It should be noted that the revised report on internal control presented in paragraph 3 does not change the independent auditor's responsibilities to detect or report material inadequacies as described in CFTC Regulation 1.16(d).

Report on Internal Control Required by CFTC Regulation 1.16

[3.] The illustration of the independent auditor's report on the internal control structure required by CFTC Regulation 1.16 has been incorporated into exhibit K of appendix A of the guide.

Effective Date

4. This statement is effective for reports issued on or after March 1, 1990.

* SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, supersedes SAS No. 30.

Appendix E**Statement of
Position****90-3****Definition of the Term
Substantially the Same for
Holders of Debt Instruments, as
Used in Certain Audit Guides
and a Statement of Position****February 13, 1990****Amendment to AICPA Industry Audit Guide
Audits of Banks and AICPA Audit and Accounting
Guide *Audits of Brokers and Dealers in Securities*****Issued by
Accounting Standards Division****American Institute of
Certified Public Accountants*****AICPA***

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

SUMMARY

This statement of position provides guidance for determining whether two debt instruments are substantially the same for the purpose of determining whether a transaction involving a sale and purchase or an exchange of debt instruments should be accounted for as a sale or as a financing. This statement of position establishes six criteria, all of which must be met for two debt instruments to be considered substantially the same. It amends AICPA Industry Audit Guide *Audits of Banks* and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*. This statement of position applies to transactions entered into after March 31, 1990.

Statement of Position 90-3 Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position

Scope

1. This statement of position provides guidance for determining whether two debt instruments are *substantially the same*. The recommendations herein are limited to transactions involving a sale and purchase or exchange of debt instruments between entities who hold the debt instruments as an asset. The term *debt instruments* is used in this statement of position to include instruments usually considered to be securities such as notes, bonds, and debentures, as well as other evidence of indebtedness such as money market instruments, certificates of deposit, mortgage loans, commercial loans, and commercial paper, that often are not referred to as securities. Debt instruments also include evidence of indebtedness that represents aggregations of debt instruments, such as mortgage-backed certificates.

2. The conclusions in this statement of position are not intended to modify, in any way, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. Paragraph 42 of SFAS No. 15 discusses certain situations in which troubled debt restructurings may involve substituting debt of other business enterprises, individuals, or governmental units for that of the troubled debtors. The accounting principles in paragraph 42 of SFAS No. 15 are not affected by this statement of position. Also, this statement of position is not intended to apply to situations in which financial institutions originate or buy whole loan mortgages and exchange those loans for a participation certificate issued by government-sponsored enterprises or agencies (FHLMC, FNMA, or GNMA) representing direct ownership of the same mortgages. However, the statement of position does apply to exchanges of participation certificates.

3. The recommendations in this statement of position amend AICPA Industry Audit Guide *Audits of Banks* (Bank Audit Guide) and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (Broker-Dealer Guide).

Background

4. The preface of the Bank Audit Guide states that certain issues affecting the banking industry are not included in the guide or are under study by the AICPA or the FASB. One of those issues relates to the definition of the term *substantially the same* as used in the guide.

5. In paragraphs 5.21 and 5.22 of the Bank Audit Guide, the term *substantially the same* is used in describing wash sales as follows:

Bank supervisory agencies currently prescribe that investment security gains and losses be recognized according to the completed transaction method. In practice, serious questions develop about the proper definition of "completed transactions" when securities are sold with the intent to reacquire the same or *substantially the same* securities, most often to obtain income tax or

other benefits. In such transactions, known as “wash sales,” the period of time between sale and reacquisition varies. It is often very short, especially when readily marketable securities are involved. In some cases, the security or evidence of ownership of the security remains in the possession of the seller or his agent; only brokers’ advices provide evidence of the sale and reacquisition.

In a sale, the risks and opportunities of ownership are transferred for a reasonable period of time; such a transfer is necessary to constitute realization and permit recognition of revenue. Therefore, when a bank sells a security and concurrently reinvests the proceeds from the sale in the same or *substantially the same* security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. When the proceeds are not reinvested immediately, but soon thereafter, the test is whether the bank was at risk for a reasonable period of time to warrant recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank’s liquidity requirements may require that a long-term bond be replaced by a short-term money market instrument; but, a week later, the bank’s liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond. [*Emphasis added.*]

6. The terms *substantially the same*, *substantially similar*, and *substantially identical* are also used to describe a factor that is considered in determining whether a sale of a debt instrument under an agreement to repurchase should be accounted for as a sale and a purchase or as a financing transaction. Dollar repurchase—dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

7. A dollar repurchase—dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back securities of the same issuer but not the original securities. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

[8.] [Paragraph deleted August 1991, by the Audit and Accounting Guide *Audits of Savings Institutions*.]

9. The term *substantially identical* is also used by brokers and dealers in discussing repurchase transactions. The AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* states the following in paragraph 1.40:

A repurchase transaction, commonly known as a repo transaction, is a sale of security coupled with an agreement by the seller to repurchase the same or *substantially identical* security at a stated price. . . .

A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or

substantially identical security at a definite price at a specific future date. [Emphasis added.]

The Broker/Dealer Guide does not provide any guidance for determining whether the securities are *substantially identical*.

10. Because of the lack of an authoritative definition of *substantially the same*, alternative accounting practices have developed or may develop for the exchange of *substantially the same* assets.

Current Accounting Practices

11. The issue of whether two debt instruments are *substantially the same* is generally encountered in connection with determining whether a transaction involving debt instruments results in a sale or a financing, for example, the sale of a debt instrument under an agreement to repurchase another debt instrument. If the debt instrument to be repurchased is *substantially the same* as a debt instrument sold, it may be viewed as a financing transaction. However, if the debt instrument to be repurchased is viewed as not being *substantially the same*, that transaction is generally recorded as a sale with a commitment to buy another debt instrument.

12. Two debt instruments can differ in a variety of ways, such as the obligor, maturity, interest rate, and yield. If two debt instruments are exchanged and many of the characteristics of the instruments differ, for example, exchange of a U.S. Treasury bill for a mortgage-backed security, virtually all would agree that a transaction has taken place that requires accounting recognition as a sale, not a financing. In contrast, if two debt instruments are exchanged and most of the characteristics of the instruments are the same, many would view the exchange as involving *substantially the same* securities prohibiting accounting recognition, for example, the exchange of two GNMA securities bearing the identical contractual interest rate that are collateralized by similar pools of mortgages resulting in approximately the same yield. Thus, the issue to resolve is how similar the characteristics of two debt instruments have to be viewed as *substantially the same*.

Conclusions

13. To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of *substantially the same* should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be *substantially the same*, all the following criteria must be met:

- a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.¹
- b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.²

¹ The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered *substantially the same*.

² For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

- c. The debt instruments must bear the identical contractual interest rate.
- d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.³
- e. Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.⁴

Effective Date and Transition

14. The conclusions of this statement of position should be applied prospectively to transactions entered into after March 31, 1990. However, previously issued annual or interim financial statements should not be restated.

³ For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

⁴ Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by PSA.

Appendix F

Schedule of Changes Made to Audits of Brokers and Dealers in Securities

<u>Reference</u>	<u>Change</u>	<u>Date</u>
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraphs 2.01, 2.04, 2.05, and 2.17	Conformed to the terminology used in FASB Statement No. 95.	May, 1992
Paragraph 2.37 (footnote 5)	Notation of issuance of FASB Statement No. 94 added.	October, 1990
Chapter 3 (title) & paragraphs 3.01, 3.02, 3.04, 3.05, 3.06, and 3.09	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 3.10	Reference changed from SAS No. 9 to SAS No. 65.	May, 1992
Paragraph 3.10	Revised to reflect the issuance of SSAE No. 2.	May, 1994
Paragraphs 3.11 (caption) and 3.12	Conformed to the terminology used in SAS No. 60.	May, 1992
Paragraph 3.12	Note reference revised to reflect the issuance of SSAE No. 2.	May, 1994
Paragraph 3.13	Conformed to the terminology used in SAS No. 60.	May, 1992
Paragraph 3.13	Note reference revised to reflect the issuance of SSAE No. 2.	May, 1994
Paragraph 4.07	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 4.10	Paragraph revised.	May, 1993
Paragraph 4.14	Reference changed from SAS No. 9 to SAS No. 65.	May, 1992
Paragraphs 4.18 and 4.19	Conformed to the terminology used in SAS No. 70.	May, 1993
Paragraph 4.23	Reference to SAS No. 67 added.	May, 1992
Paragraph 4.24	Reference changed from SAS No. 1, section 331 to SAS No. 67.	May, 1992
Paragraph 4.42	Conformed to the terminology used in SAS No. 55.	May, 1992

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Paragraph 4.51	Conformed to the terminology used in SAS No. 70.	May, 1993
Paragraph 4.62	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 5.05	Reference to Veteran's Administration changed to Department of Veteran's Affairs.	May, 1992
Paragraphs 5.14, 6.18, and 7.45	Conformed to the terminology used in SAS No. 55.	May, 1992
Paragraph 7.48	Conformed to the terminology used in SAS No. 70.	May, 1993
Paragraph 7.50	Reference to SAS No. 1, section 901 conformed to current <i>Codification of Statements on Auditing Standards</i> .	October, 1990
Appendix A	Introduction modified.	May, 1993
Appendix A (Exhibit A)	SOP 89-1 integrated into text to conform to SAS No. 58.	October, 1990
Appendix A (Exhibit F)	Notation of issuance of FASB Statement No. 95 added.	October, 1990
Appendix A (Exhibit G)	Note 12 (pension plans) deleted; Reference to FASB Statement No. 87 added.	May, 1992
Appendix A (Exhibit G)	Note 15 (income taxes)—Notation of issuance of FASB Statement No. 109 added.	May, 1993
Appendix A (Exhibits I and J)	SOP 89-4 integrated into text to conform to SAS No. 60.	October, 1990
Appendix A (Exhibit K)	SOP 90-2 integrated into text to conform to SAS No. 60.	October, 1990
Appendix A (Exhibit M)	Conformed to the terminology used in SAS Nos. 55 and 58 and FASB Statement No. 95.	May, 1994
Appendix B	SOP 89-1 added.	May, 1992
Appendix C	SOP 89-4 added.	May, 1992
Appendix C	Note reference to the issuance of SSAE No. 2 added.	May, 1994
Appendix D	SOP 90-2 added.	May, 1992
Appendix D	Note reference to the issuance of SSAE No. 2 added.	May, 1994
Appendix E	SOP 90-3 added.	March, 1991

<u>Reference</u>	<u>Change</u>	<u>Date</u>
Appendix E	References to Audit and Accounting Guide <i>Savings and Loan Associations</i> and SOP 85-2 deleted.	August, 1991
Appendix E	Notice to Readers revised to reflect the issuance of SAS No. 69.	May, 1992
In addition to the above, notes have been added to highlight areas that will be updated in future editions. These areas include:		
Appendix A, Exhibit F, will be replaced by an illustrative statement of cash flows.		

Glossary

General Terms

Account executive. See *registered representative*.

Active box. A position on the stock record (street side) indicating securities located in the cashier's department that are normally available to the broker or dealer for its general use.

Adequately collateralized. Indebtedness for which the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks that regularly make comparable loans to brokers or dealers in the community.

ADR. Abbreviation for American Depository Receipt. A certificate issued by a U.S. bank that serves as evidence of ownership of original foreign shares. These certificates are transferable and can be traded. The original foreign stock certificates are deposited with a foreign branch or foreign correspondent bank of the issuing U.S. bank.

Aggregate indebtedness. The total of certain liabilities of a broker or dealer that are set forth in SEC rule 15c3-1. The rule states that a broker or dealer shall not permit its aggregate indebtedness to exceed a specified percentage of its net capital as defined in the rule.

Allied member. Any general partner or qualified voting stockholder of a member organization who is not himself a member of a stock exchange.

Amex. Popular name for the American Stock Exchange.

Arbitrage. The act of buying a security in one market and simultaneously selling it in another in order to profit from price discrepancies. Also, buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion, or reorganization.

Asked. The price a seller is willing to accept for a security at a particular time.

Back office. The administrative area of a brokerage office, containing the bookkeeping, margin, purchase and sales (P&S), cashier's, and dividend departments.

Bad delivery. A delivery of securities that does not fulfill the requirements for delivery.

Balance order. The net balance instructions, issued by a clearing corporation, to receive or deliver securities. The instructions give all the information needed by the member firm to clear its transactions on a given settlement date.

Basis point. A measurement of changes in price or yields for fixed income securities. One basis point equals .01 or ten cents per one thousand dollars per annum.

Best efforts. Refers to an agreement by an underwriter to buy from the issuing corporation only those securities it is able to sell to the public.

Bid. The price a buyer is willing to pay for a security at a particular time.

Big Board. Popular name for the New York Stock Exchange.

Block trading. The acquisition or disposition of large quantities (10,000 shares or more) or "blocks" of stock by a broker or dealer in order to facilitate the execution of buy and sell orders of customers, usually institutions. Often a broker or dealer absorbs a portion of the order for its own account and risk.

Blotter. A record of original entry. A book or individual unit used as a record of original entry to record transactions as they occur. It covers purchases, sales, cash receipts and disbursements, and securities received and delivered.

Blue list. Listing of municipal bonds offered for sale.

Board room. Popular name for the area in a broker's or dealer's office where customers can see postings of security prices and activity and enter orders to purchase and sell securities.

Books closed. The cutoff time that determines stockholders of record for a prescribed period. Any entries affecting the registration or ownership of securities for dividend disbursements or proxy purposes must be made before this time.

Borrowed. The act of borrowing a security for delivery. The equivalent value in money is usually deposited with the lender.

Box. A "short" position in the stock record representing securities on hand in the possession of the broker or dealer. A place where securities are kept such as a vault, file cabinet, and so forth. "Boxes" are also identified as "safekeeping box," "segregation box," "name-of box," "active box," and so forth.

Box count. An actual count of the securities in the box either in connection with an audit or with periodic checking.

Box spread. A combination of long calls and short puts, identical with respect to the underlying security issue, number of shares, exercise price, and expiration date; coupled with long puts and short calls, identical with respect to the underlying security issue, number of shares, exercise price, and expiration date. In boxing (coupling) the long calls and short puts with the long puts and short calls, the underlying security issue, number of shares, and expiration date remain identical. However, the exercise price of each combination is at a different amount.

Break. The term applied to that position in the stock record to designate an out-of-balance position between the stock record long and short positions.

Broker loans. Money borrowed by brokers from banks.

Broker's transfer account. An account kept by the transfer clerk of a broker or dealer giving details of securities transferred for the account of other brokers or dealers. The need for the account arises when delivery is made by transfer as directed (TAD) instead of by delivery of the actual certificates.

Bulk segregation. Securities (usually constituting excess collateral in margin accounts) that are filed in alphabetical order in special boxes in the vault but that are not specifically identified by owner. The securities are usually in the name of the broker or dealer, who maintains collateral records that indicate the owners.

Buy-in. The procedure followed by a broker or dealer desiring to settle a buy contract that is past due. The broker or dealer may file with a stock exchange or the National Association of Security Dealers, Inc., as ap-

proate, a notice termed a buy-in. A copy of the notice is also served on the broker or dealer from whom the securities were to be received. If the securities are not delivered, the stock or bond may be bought in for cash for the account of the broker or dealer from whom the securities are to be received. The difference in price between the buy-in and the contract price is adjusted by check from one broker or dealer to another.

Buying power. The equity remaining in a margin account after providing for the margining of existing securities in the account in accordance with federal and "house" margin requirements.

Cage. The term given to the area of the broker's or dealer's office where the cashier, stock clerks, loan clerks, transfer clerks, blotter clerks, and others have, as a part of their duties, responsibility for receiving and delivering securities.

Call (margin). A request, usually in writing, for a margin customer to put up additional collateral (cash or securities).

Call loan. A loan that has no definite maturity or rate of interest. The loan may be either "called" by the lender or paid off by the borrower at any time.

Call option. A contract that entitles the holder to buy (call), entirely at his option, a specified number of underlying units of a particular security at a specified price at any time until the stated expiration date of the contract. Such an option (which is always for a round lot amount and which is transferable) is bought with the expectation that the price will rise above the contract price. If the price rises as anticipated, the purchaser will exercise the option; if it does not, he will let the option expire and will lose only the cost of the option. With the advent of registered national exchanges for option trading, there is now both a listed and over-the-counter (OTC) market in options. (During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the expiration date for cash dividends, rights, and stock dividends or splits.)

Cash account. The account of a customer of a broker or dealer who purchases and sells securities strictly on a cash basis. No credit margin is allowed.

Cash sale. A sale with the same trade and settlement dates. The selling broker or dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.

Cash transaction. A transaction that is expected to clear within the time prescribed by Regulation T of the Board of Governors of the Federal Reserve System.

Cashier's department. A division of the operations department of a broker or dealer that handles securities and money that are received or delivered by the broker or dealer. (See *cage*.)

CBOE. Abbreviation for Chicago Board Options Exchange, a national securities exchange based in Chicago that provides a continuous market for trading in put and call options. Various other exchanges such as the American, Pacific, and Philadelphia also provide such markets.

Churning. The process of unnecessary purchases and sales in customers' accounts for the purpose of generating commissions.

Clearance. The act of clearing securities between buyers and sellers; receipt or delivery of securities against payment.

Clearing house. The central location for matching security transactions of members to enable the determination of minimum quantities to be received or delivered.

Clearing member. A broker or dealer entitled to use the services of the clearing corporation.

Clearing number. A number assigned to a member by a clearing organization in order to identify that clearing member.

Clearing organization. Usually a broker or dealer that clears the transaction of another broker or dealer. (See *correspondent*.)

Comparison. A formal notice that details the terms of the contract between brokers or dealers who are parties to nonexchange trades. If the details of the trade are correct, the comparison is stamped (acknowledged) and returned; if they are incorrect, the broker or dealer indicates the differences and returns the comparison. (See *D.K.*)

Compliance department. The department of a broker or dealer that enforces adherence to policies established by the broker or dealer plus all rules and regulations fixed by the various regulatory agencies.

Confirmation. A notice that sets forth the terms of a contract between a broker or dealer and its customer for the purchase or sale of securities. Details shown on a confirmation are trade date, settlement date, number of shares or par value of bonds, security description, contract price, commission, account number and type of account, customer's name and address, and any other information required.

Contract sheet. A listing of compared and un-compared transactions sent to each member firm by a stock clearing corporation.

Control stock. Securities of an issuer that are owned by an affiliate of that issuer. An "affiliate" of that issuer is a person who, directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the issuer. Control is likely to be found where the person is a director, officer, or owner of a relatively large number of the issuing company's voting securities. However, the notion of control is a factual matter that is determined on a case-by-case basis.

Conversion account. A transaction involving the purchase of an underlying security and one put, and the simultaneous sale of one call at the same exercise price as the put.

Correspondent. One of the parties to an agreement between two brokers or dealers that perform services for each other, such as the execution and the clearance of trades. A New York City broker or dealer (a clearing member) is usually the correspondent for an out-of-town broker or dealer (often a nonmember).

Cover value. The amount necessary to buy-in a "short" security position at the current market value.

Credit department. See *margin department*.

Current market value. As used in connection with margin trading, generally means the closing price of a security as of the preceding business day.

CUSIP (number). A means of uniformly describing and identifying specific security issues in numeric form. Developed by the Committee on Uniform Security Identification Procedure.

Customers' man. A salesman or registered representative.

- DAP.** Abbreviation for delivery against payment. Also referred to as COD (cash on delivery), POD (payment on delivery), and DVP (delivery versus payment).
- Day loan.** A loan made for only one day, generally on an unsecured basis, for the convenience of the broker or dealer.
- Dealer.** A person or firm acting as a principal rather than as an agent in the purchase and sale of securities.
- Definitive certificates.** Actual and permanent certificates of bonds or stock given in exchange for temporary receipts. These temporary receipts are usually issued at the time of a new offering before the engraved certificates are available.
- Delayed delivery.** A transaction involving deferral of settlement date, which is normally five business days for securities and one business day for options, to some point further in the future as agreed on by both buyer and seller. (See *seller's option*.)
- Directed sale.** Sale by the manager of a syndicate to a customer (usually an institution) of a syndicate member.
- Discretionary account.** An account over which a broker or dealer or some other person has been given authority by the customer to make decisions concerning purchases and sales of securities, including the kind of securities to buy or sell, as well as the time when and the prices to be paid or received. The discretion may be complete or limited.
- Distribution.** The sale of a large block of securities to the investing public.
- Divided liability.** Liability in a syndicate or underwriting that is fixed or definite in amount. (See *undivided liability*.)
- Dividend department.** A division of the operations department that is charged with the collection of dividends and the crediting of these dividends to the accounts of customers.
- D.K.** Abbreviation for don't know. An expression used by a broker or dealer to indicate that a certain transaction that another broker or dealer is attempting to confirm or compare is unknown to it. When mutual understanding is reached, the transaction is properly compared or cancelled.
- DTC.** Abbreviation for Depository Trust Company. A depository for eligible securities that facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates.
- Due bill.** A document passed between brokers or dealers stating that dividends, rights to subscribe, stock dividends, and so forth, are the property of the holder of the due bill.
- Equity.** The net worth in an account carried by a broker or dealer, computed by subtracting the total of the "short" security values and the debit balance from the total of the "long" security values and the credit balance. If the result is a net credit, the account is said to liquidate to an equity.
- Equity securities.** Term applied to common stocks or to debentures or preferred stocks that are convertible into common stocks.
- Equity statements (runs).** Statements showing details of an account together with security valuations.

Exchange tickets. The tickets in a clearing corporation format, prepared by a broker or dealer for each transaction made on an exchange. These tickets list all pertinent details of the trade and are sent along with a daily summary listing to the clearing corporation for comparison and confirmation.

Ex-clearing house. Transactions that are not settled through the clearing house.

Ex-dividend. Synonym for "without dividend." The buyer of a stock selling ex-dividend does not receive the recently declared dividend. Open buy and sell stop orders and sell stop limit orders in a stock on the ex-dividend date are ordinarily reduced by the value of the particular dividend. In the case of open stop limit orders to sell, both the stop price and the limit price are reduced. Every dividend is payable on a fixed date to all shareholders recorded on the books of the disbursing company as of a previous date of record. For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Since five business days are allowed for delivery of the security regular-way in transactions on a stock exchange, the exchange would declare the stock ex-dividend as of the opening of the market on the preceding Monday. This means that anyone buying the stock on and after Monday would not be entitled to the dividend.

Ex-rights. Same principle as ex-dividend. The buyer of stock selling ex-rights is not entitled to the rights distribution.

Ex-warrants. On occasion, stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. When these warrants are detached, the security is traded ex-warrants.

Execution report. A confirmation notice of the completion of a trade that is sent from the floor of an exchange (for listed securities) or trading desk (for over-the-counter securities) back to the point of origin of the order.

Exempt securities. Securities exempted from registration under the Securities Exchange Act of 1934, rather than by action of the Securities and Exchange Commission.

Extension. Permission to extend credit beyond the time prescribed by Regulation T of the Board of Governors of the Federal Reserve System.

Fail-to-deliver. Securities that the selling broker or dealer has not delivered to the purchasing broker or dealer at the settlement date.

Fail-to-receive. Securities that the purchasing broker or dealer has not received from the selling broker or dealer at the settlement date.

Fails. Uncompleted security transactions between two brokers or dealers. (See *fail-to-deliver* and *fail-to-receive*.)

Firm account. An account consisting of securities in which the broker or dealer has taken a position for investment purposes, is making a market (principal wholesaler), or has an interest with another party (joint account).

Firm commitment. Refers to the agreement of an underwriter to buy the entire issue of a security from the issuing corporation at a specified price.

Firm price. The price at which a security can be bought or sold in the over-the-counter market for such period of time as the seller may specify.

- Flat.** A method of trading in certain kinds of bonds. Usually used in trading income bonds that do not pay interest unless it has been earned and declared payable, or in bonds on which the issuing corporation has defaulted in the payment of interest. When bonds are traded "flat," the seller is not entitled to receive in addition to the price of the bond the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded flat must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuing corporation in the future.
- Flat statement.** A statement with no money or security balance.
- Floor.** Popular name for the area where securities are bought or sold on an exchange.
- Floor broker.** Member of exchange who executes transactions on the exchange for the account of his own organization or for the account of other member organizations.
- Floor brokerage.** The commission charged by one broker or dealer to another for executions of transactions on exchanges.
- Floor clerk.** An employee of a broker or dealer who maintains a liaison between the order room and the floor broker.
- Floor report.** A report of an executed trade given to the floor clerk by the floor broker, which contains the number of shares, the price, and the other broker on the trade.
- FOCUS.** Abbreviation for Financial and Operational Combined Uniform Single report. The uniform regulatory report (Form X-17A-5) filed periodically by all brokers and dealers pursuant to rule 17a-5 of the Securities and Exchange Commission.
- Free securities.** Securities that are fully paid for.
- Free shipment.** Shipments of securities, usually to out-of-town brokers or dealers, without draft attached in order to avoid payment of collection charges.
- Fully disclosed basis.** Where a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement is carried by, and disclosed to, that clearing broker.
- Fully paid accounts.** Customer accounts in which the contract price to purchase securities has been paid. These securities should be "locked up" in the segregation or safekeeping box.
- Give-up.** Type of order that is given by a customer to a member firm on whose books the customer does not have an account.
- Good delivery.** Certain basic qualifications must be met before a security sold may be delivered. The security must be in proper form to comply with the contract of sale and to transfer title by delivery to the purchaser.
- Good-faith deposit.** Deposit to guarantee performance, usually with respect to new issues of securities.
- Group account.** A syndicate or joint account.
- GTC.** Abbreviation for good 'til cancelled. Also called an open order. When this term appears on an order to buy or sell a security, it means that the order is to remain in effect until it is either executed or cancelled.

Haircut. Deductions from net capital of certain specified percentages of the market value of securities and future commodity contracts “long” and “short” in the capital and proprietary accounts of a broker or dealer and in the accounts of partners. These deductions are solely for the purpose of computing net capital and are not entered on the books.

Holder-of-record. The party listed as the registered owner on the transfer records of a corporation.

Holders’ file. A subsidiary file (punched cards, discs, or tapes) in account sequence showing securities owned or carried in such accounts.

House account. An account used by a broker or dealer to maintain a trading or investment position in a security for itself or its officers or partners. Also, a name given to a customer’s account to which no registered representative has been assigned.

House rules. Rules promulgated by the broker or dealer. Usually refers to the maintenance margin required by the broker or dealer over and above the requirements of governing bodies.

Hypothecation agreement. An agreement signed by a customer that permits his broker to use securities in the customer’s margin account as collateral for loans made to the broker.

In-box sheet. Sheet that includes a list of items going into the box.

In house. Within the broker’s or dealer’s firm.

Initial margin. The amount of money or its equivalent specified by the Board of Governors of the Federal Reserve System that a customer must deposit with his broker when the customer buys a security on margin.

International arbitrage. Same as *arbitrage*, except the markets are in different countries.

Investment banker. One who underwrites securities on an initial or secondary basis. This type of underwriting often involves private placements where the investment banker may act as both a broker and a dealer.

Joint account. An account in which two or more persons have an interest.

Legal list. A list of securities in which insurance companies, banks, and fiduciaries are permitted by law to invest.

Legal transfer. A stock certificate having an assignment executed by an executor, administrator, trustee, guardian, and so forth, and requiring certain legal documents indicating the authority of the party signing the securities.

Letter of credit. An unqualified commitment issued by banks or trust companies to pay a specified sum of money immediately upon demand at any time prior to the expiration of the letter of credit. Most commonly used by brokers and dealers to satisfy margin requirements at the Options Clearing Corporation or commodity clearing organizations or in stock borrowed transactions.

Limit order. An order to buy or sell a security at a price specified by the customer or at a better price if such price can be obtained. Also called a limited order or limited price order.

Listed security. A security that is traded on an exchange.

Loan consent. An agreement signed by a customer that permits the broker or dealer to lend securities in a margin account to other brokers or dealers.

- Loan value.** The value at which a security is accepted for margin. This value is usually less than or at a discount from current market value.
- Loaned.** The act of lending a security usually for delivery against a short sale. The equivalent value in money is usually deposited by the borrower. Opposite of borrowed.
- Lock-up.** The act of placing securities in safekeeping or segregation.
- Long.** Denotes ownership or right to possession of securities.
- Long and short record.** See *stock record*.
- Long securities differences.** The excess of securities positions accounted for over the broker's or dealer's long positions on the stock record. When recorded in a difference account, the excess would be recorded long on the stock record. (See *short securities differences*.)
- Maintenance margin.** The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules.
- Margin.** The equity in an account. The requirements for the amount of margin vary between initial margin and maintenance margin and also according to the type of collateral used in computing the equity.
- Margin call.** A request for additional margin.
- Margin department.** A division of the operations department. Its function is to keep an up-to-date record of each customer's purchases and sales of securities and to carefully watch margin transactions in a customer's margin account.
- Margin transaction.** A transaction on which the broker or dealer advances credit to the customer for a portion of the purchase price.
- Mark-to-market.** Term used to describe the value (market value or fair value) of security positions, and which is recognized as the generally accepted accounting principle for purposes of determining profit or loss on security positions in proprietary trading and investment accounts. The term also is applied to open contracts between brokers and clearing corporations in determining the adjustments to be made for funds owed or receivable to adjust those contracts to current values.
- Mark-up.** Refers to the difference between what a dealer has paid for a security and the price at which it offers the security to another person.
- Market maker.** A broker or dealer that stands ready to buy or sell a particular security in the over-the-counter market at prices the broker or dealer has quoted. Also, an options trader on the floor of a registered exchange who stands ready to buy or sell a particular option.
- Market price.** Usually means the last reported price at which a security has been sold.
- Master file.** A file that contains the official account numbers and descriptions of securities and customers' names and addresses.
- Matrix pricing.** A mathematical technique used to value normal institutional size trading units of debt securities without relying exclusively on quoted prices. Factors such as the issue's coupon or stated interest rate, maturity, rating, and quoted prices of similar issues are considered in developing the issue's current market yield.
- Maximum loan value.** Refers to the percentage of the purchase price of a security that a broker or dealer may lend to a customer who is buying a security on margin.

Member corporation. A broker or dealer that is organized as a corporation and that has at least one director-holder of voting stock who is a member of an organized stock exchange.

Member firm. A broker or dealer that is organized as a partnership and that has at least one general partner who is a member of an organized stock exchange.

Mixed account. An account containing both long and short securities.

Municipal Securities Rulemaking Board. Agency established by Congress to establish rules for brokers and dealers effecting transactions in obligations of, or guaranteed by, state or local governments or any political subdivision, agency, or instrumentality thereof.

Name-of securities. Securities registered in the name of customers of the broker or dealer.

NASD. Abbreviation for National Association of Securities Dealers, Inc. An association of brokers and dealers who do business in the over-the-counter market. The association supervises and regulates the trading conduct of its members.

NASDAQ. An electronic quotation system for the over-the-counter market sponsored by the National Association of Securities Dealers, Inc.

Net capital. Net worth of a broker or dealer less certain items such as exchange memberships, carrying value of securities that are not readily marketable, "haircuts" on marketable securities in proprietary accounts, furniture and equipment, and so forth, as defined in the net capital rules.

New issue. A security that is sold by an issuing corporation for the first time; it may be referred to as initial public offering (IPO).

NSCC. Abbreviation for National Securities Clearing Corporation, which is an independent organization established by the New York and American Stock Exchanges and the National Association of Securities Dealers as an equally owned subsidiary to provide trade processing, clearance, delivery, and settlement services to its members. It deals with brokers, dealers, and banks in the United States and Canada.

NYSE. Abbreviation for New York Stock Exchange. A not-for-profit corporation that is the largest securities exchange in the United States. This self-regulatory organization also furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

Odd lot. A quantity of securities that is less than the trading unit, usually a quantity less than an even 100 shares.

Odd-lot differential. The fraction that is added to or deducted from the round lot price by the odd-lot broker.

Off-board. Trading in unlisted securities in the over-the-counter market. Also used to describe transactions in listed securities not executed on a stock exchange.

Offer. The lowest price at which a seller is willing to sell a security.

Omnibus account. An open account carried and cleared by another broker or dealer containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker or dealer introducing the trade.

- Operations department.** The name associated with the overall clerical functions of a broker or dealer. Sometimes referred to as the back office.
- Option conversion accounts.** Accounts consisting of long options and short options positions and a related underlying securities position. (See *conversion account* and *reverse conversion*.)
- Optional dividend.** A dividend that is payable in either stock or cash at the option of the holder of record.
- Order board officials.** Personnel of the Chicago Board Options Exchange (CBOE) whose duties are similar to those of specialists on a registered national stock exchange.
- Order department.** A division of the operations department that receives customers' orders and transmits them either to the floor of a stock exchange or to the trading department for execution. The order department also receives notices of executed trades and transmits such notices to the purchases and sales department and to the registered representatives.
- Order room.** Another name for the order department.
- OTC.** Abbreviation for over the counter. A market for securities made up of brokers or dealers who may or may not be members of a securities exchange. Thousands of companies have insufficient shares outstanding, stockholders, or earnings to warrant application for listing on a stock exchange. Securities of these and other companies are traded in the over-the-counter market between brokers and dealers who act as either principals or brokers for customers. The over-the-counter market is the principal market for U.S. government bonds and municipal securities.
- Out-of-box sheet.** A sheet listing securities removed from the box.
- Over-delivery.** Delivering a greater amount of securities than called for, the surplus amount being returned by transferring it to the name of the delivering broker or dealer. An over delivery can also occur when excess securities are delivered in error.
- Over the window.** The direct delivery of securities between two brokerage concerns, rather than by use of the clearing house facilities. Delivery is made by hand to the receive window of the broker and is said to be "over the window."
- Pair off.** When two brokers or dealers owe each other the same number of shares of the same security. Instead of actually receiving the security and delivering it back again, they will "pair off" the transaction by giving or receiving a check for the difference in price or exchanging checks for the full amount of each side of the transaction.
- Papers.** A term sometimes given to put and call options.
- Payable date.** The date on which a dividend is payable to holders of record as of some previous date.
- P/E.** Abbreviation for price-earnings ratio. The market value of a share of stock divided by its earnings per share.
- Pink sheets.** A listing of over-the-counter securities published on pink paper by the National Quotation Bureau. It shows the most recent bid and asked prices for the securities listed, as well as the brokers and dealers making a market in those securities. While pink paper is used for stock quotations, the definition also applies to listing of bond quotations, and so forth, which are printed on papers of different color.

Point. When used in connection with the purchase or sale of stocks, "point" means a rise or decline of \$1 per share. When used in connection with the purchase or sale of bonds, it means a rise or decline of \$10 per \$1,000 principal amount.

Position. This term is used in referring to the securities "long" or "short" in an account or in the stock record.

Post. A designated place on an exchange floor where specific securities must be traded.

Private placement. The direct sale of a block of securities, either a new issue or a secondary issue, to a single investor or a group of investors. This is usually accomplished through an investment banker.

Proxy department. A division of the operations department that helps corporations communicate with their stockholders in cases where stock certificates are in street name.

Purchase and sales department. A division of the operations department that is concerned with the preparation of customers' confirmations of security transactions and the comparison of such transactions with other brokerage concerns.

Put option. A contract that entitles the holder to sell (put), entirely at his option, a specified number of underlying units of a particular security at a specified price anytime until the stated expiration date of the contract. Such an option (which is always for a round-lot amount and which is transferable) is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise the option. If the decline does not occur, he will let the option expire and will lose only the cost of the option. With the advent of registered national exchanges for option trading, there are now both listed and over-the-counter (OTC) markets in options. (During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.)

Puts and calls. Options to sell (put) or buy (call) securities within a specified period of time at specified prices. (See *put option*, *call option*, and *straddle*.)

Quote. The price of a security. It may be the price of the last sale made on an exchange or the current bid and asked price.

Receive-and-deliver department. A division of the operations department responsible for the physical receipts and delivery of incoming and outgoing securities. Often, it is also responsible for the daily balancing of cash entries made by the various operations departments.

Record date. The date on which the stockholder's name must be registered on the books of a company in order to receive a declared dividend or, among other things, to vote on company affairs.

Registered owner. The owner of a security, whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

Registered representative. Name given to a salesman of the broker or dealer. Salesmen are registered with the exchange of which the broker or dealer is a member.

Registered trader. Individuals or entities who have obtained approval to trade for their own account on the floor of a national securities exchange.

Such individuals or entities have certain obligations with regard to stabilization of the market in securities for which they are registered. They also have less stringent financial responsibilities and reporting requirements than full service brokers or dealers.

Registrar. Usually a trust company or bank charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.

Regular-way delivery. Unless otherwise specified, securities (other than those of the U.S. government) are to be delivered to the buying broker or dealer by the selling broker or dealer, and payments are to be made on the fifth business day after the transaction. The regular-way delivery day for government bonds is the business day following the transaction.

Regulation G. The Federal Reserve Board's regulation governing the amount of credit that persons other than banks or brokers or dealers may extend to investors who borrow money to buy securities on margin.

Regulation T. The Federal Reserve Board's regulation governing the amount of credit that brokers and dealers may extend to customers who buy securities.

Regulation U. The Federal Reserve Board's regulation governing the amount of credit that banks may extend to customers who borrow money to buy securities on margin.

Regulation X. The Federal Reserve Board's regulation specifying conditions with which a borrower must comply when obtaining credit for the purpose of purchasing or carrying securities.

Reorganization department. A division of the operations department that processes securities involving corporate reorganizations, mergers, consolidations, subscriptions, and the exchange of convertible securities into common stocks.

Repurchase agreement (repo agreement). (Usually a U.S. government obligation or corporate debt instrument.) The sale of a security at a specified price with a simultaneous agreement to repurchase the security at a specified price on a specified future date. An agreed-upon interest rate is accrued by the seller-repurchaser over the life of the contract. For financial reporting purposes, the security is treated as part of the broker's or dealer's trading and investment inventory with the amount of the repurchase agreement reflected as a liability.

Restricted account. Means that a broker may not buy securities for a particular customer for a specified period of time unless the customer has deposited enough money in his account to pay for the securities before his orders are executed.

Reverse conversion. A transaction involving the sale of an underlying security and one put, and the simultaneous purchase of one call at the same exercise price as the put.

Reverse repurchase agreement (reverse repo). An agreement whereby the purchaser of securities agrees to resell the securities within a specified time at a specified price. (See *repurchase agreement*.)

Reverse split. Opposite of *stock split*.

Rights. The privilege offered by a corporation to its stockholders to subscribe to certain securities at an advantageous price.

Round lot. A unit of trading or a multiple thereof. On the New York Stock Exchange the unit of trading is generally one hundred shares in stocks and \$1,000 par value in bonds.

Safekeeping. A position on the stock record (street side) indicating securities that have been fully paid for by customers and that are being held by the broker or dealer under custody arrangements. These securities are generally registered in the name of the customer.

Safekeeping box. Box in which customers' fully paid-for securities are kept.

SCA. Abbreviation for subsequent coupons attached.

Scrip. A certificate issued to stockholders of a corporation that may be exchanged for fractional shares of stock or the equivalent in cash by a fixed date. Scrip is usually issued in connection with a stock dividend or a stock split.

Seat. Popular name for a membership on a stock exchange.

SEC. Abbreviation for Securities and Exchange Commission. An agency established by Congress to administer federal securities laws.

Secondary distribution. The sale of a large block of securities (other than an initial issue of a corporation). It is usually the holdings of a large individual stockholder or an estate that are being liquidated.

Secondary offering. An offering of large blocks of listed securities outside of the exchange on which they are listed.

Securities borrowed. See *borrowed*.

Securities loaned. See *loaned*.

Securities not readily marketable. This term refers to (1) securities, except exempted securities, for which there is no market on a securities exchange or no independent publicly quoted market; (2) securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under section 3(b) of such act have been complied with); or (3) securities that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or the broker or dealer.

Segregation. A position on the stock record (street side) indicating customers' fully paid-for or excess margin securities that are subject to the customers' instructions and that have been set aside. These securities are generally in the name of the broker or dealer. (See *bulk segregation*.)

Segregation box. Box in which segregated securities are kept.

Sell out. Action taken by a broker or dealer to liquidate an account or transaction for failure to maintain proper margin or make timely payment.

Seller's option. Transaction that by agreement is to be settled at a date later than the usual regular-way transaction.

Selling against the box. This is similar to a *short sale* except that the seller already owns the stock being sold but keeps possession of it and so has to borrow the equivalent stock with which to make delivery to the purchaser.

Selling concession. A discount in the public offering price offered by the issuer to members of its underwriting group.

- Selling group.** A group of brokers or dealers that has formed a joint account for the sale of securities, usually in connection with an underwriting.
- Service bureau.** A data processing center that processes the transactions of brokers and dealers. These centers are located away from the broker's or dealer's office.
- Settlement date.** The date on which security transactions are to be settled by the delivery or receipt of securities and the receipt or payment of cash.
- Settlement price.** The price at which a security or commodity is to be settled. Used primarily in connection with clearing house operations.
- Short.** A stock record position (street side) that represents location (such as box, transfer, and so forth) or due from (such as failed-to-receive, owed to the brokerage concern by a customer on account of a short sale, and so forth).
- Short against box.** See *selling against the box*.
- Short covering.** Refers to the purchase of securities so that stock previously borrowed to make delivery on a short sale may be returned.
- Short sale.** A sale of securities that requires borrowing equivalent securities to make delivery to the purchaser.
- Short securities differences.** The excess of securities positions for which the broker or dealer is accountable on its stock record (longs) over those whose locations have been accounted for (short) after a securities verification. When recorded in a difference account, the excess would be recorded short on the stock record. (See *long securities differences*.)
- SIAC.** Abbreviation for Securities Industry Automation Corporation. An independent organization established by the New York and American Stock Exchanges as a jointly owned subsidiary to provide automation, data processing and clearing and communication services to the securities industry, including NSCC.
- Signature guaranteed.** In order that a registered security may be a good delivery on the exchange or a good transfer, the signature of the registered owner must be properly guaranteed. The guarantee of a stock exchange member or a bank is usually considered sufficient guarantee.
- SIPC.** Abbreviation for Securities Investor Protection Corporation, a corporation established for the purpose of protecting customers of brokers and dealers in financial difficulty.
- Special offering.** The sale of a large block of securities on the floor of the stock exchange. The sale is made in accordance with special procedures worked out by officials of the exchange.
- Specialist.** A broker who is a member of an exchange and who operates on the floor of the exchange to execute transactions and to maintain an orderly market in certain specified securities.
- Split.** The action of increasing the number of outstanding shares of stock of a company in order to decrease the market price and afford a greater distribution of the shares. For example, two shares for each share held will have the effect of reducing the price of the shares by approximately one-half.
- Spread.** A combination of a put and call option at different prices—one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security.

Stock dividend. A dividend payable in stock of the issuing corporation.

Stock power. A legal document used in lieu of the assignment section of a stock certificate. It cannot be used on a bond certificate.

Stock record. The record of individual securities on which both the long and short positions are shown; the total of the long positions and the total of the short positions should be in balance.

Stock record department. A division of the operations department that keeps up-to-date records of all securities positions, and is usually responsible for reconciling out of balance conditions.

Stock split. See *split*.

Stockholder of record. A stockholder whose name is registered on the books of the issuing corporation.

Stop order. An order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order when the price of the security reaches, or sells through, the price specified by the customer. Also called a stop loss order.

Straddle. A combination of one put and one call, identical with respect to the security issue, number of shares, exercise price, and expiration date.

Street. A shortened term for Wall Street that refers to brokers, dealers, and other financial business concerns.

Street item. A transaction or account between brokers or dealers (for example, failed-to-receive, failed-to-deliver, stock loaned, and stock borrowed).

Street name. Securities held in the name of a broker or dealer instead of in customers' names are said to be carried in street name.

Subscription. The offer to purchase a certain offering as a certain number of shares of the stipulated stock or principal amount of bonds for a stipulated amount of money. The offer is not binding unless accepted by the proper authorized representatives of the issuing corporation.

Substitution. The act of withdrawing securities from a bank loan and substituting other securities of approximate equal value.

Suspense account. An account used to record securities or monies that cannot be immediately identified and cleared (for example, reclamations, D.K. items, and bad deliveries).

Syndicate. A group of brokers or dealers who together underwrite and distribute new issues of securities or large blocks of an outstanding issue.

TAD. An abbreviation for transfer as directed.

Take-off. A daily record showing the net changes in each security. A separate record is prepared for each security and the information is used to post (update) the stock record. Also, a record of the long and short positions in a security on the record date used by the dividend department to make the appropriate dividend entries. Sometimes referred to as a daily activity list.

Tax stamp. A rubber stamp facsimile (in some instances a documentary stamp) affixed to a certificate to indicate that all applicable transfer taxes for the item have been paid.

Ticker. An instrument that prints the price at which a security has been traded on an exchange after the trade has been executed.

- Time loan.** A loan having a definite date of maturity and a specified rate of interest for the entire period.
- Trade.** A term that indicates the consummation of a security transaction, either a purchase or a sale.
- Trade date.** The date a security transaction is actually executed.
- Trader.** An employee of a broker or dealer who executes orders in the over-the-counter market for customers. Also, a person who buys or sells securities for his own or his company's account for short-term profit.
- Trading post.** Another name for post.
- Trading unit.** The unit by which the security is traded on an exchange, usually one hundred shares of stock or \$1,000 principal amount of bonds (*round lot*).
- Transfer.** Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.
- Transfer agent.** A transfer agent keeps a record of the name and address of each registered shareholder and the number of shares each owns. The agent sees that certificates presented to his office for transfer are properly cancelled and that new certificates are issued in the name of the transferee.
- Transfer department.** A division of the operations department that matches, processes, and controls securities being transferred.
- Two-dollar broker.** A name given to a member of an exchange who executes orders for other brokers on that exchange.
- Underwriting.** The act of distributing a new issue of securities or a large block of issued securities—that is, a *secondary offering*.
- Undivided liability.** An arrangement whereby each member of an underwriting syndicate is liable for his proportionate share of unsold securities in the underwriting account regardless of the number of securities he has previously sold.
- Undue concentration.** Additional “haircut” from net capital (see SEC rule 15c3-1) on the market value of certain aged proprietary security positions of a single class or series of the same issuer that exceeds 10 percent of a broker's or dealer's net capital before haircuts.
- Unit record.** A term applied to a data processing system that utilizes only punch cards.
- Unlisted security.** A security that is not listed on an exchange.
- Value date.** Same as *settlement date*.
- Valued stock record.** The stock record at examination date, with each security position other than those in segregation and safekeeping assigned a price. Remaining quantities within the position are valued at the assigned price.
- Warrants.** Rights to purchase additional securities. Usually affixed to the certificate at the time securities are originally issued. Also, a document evidencing rights, for example, a warrant for 125 rights.
- When-distributed.** Refers to the distribution of new securities. Transactions are sometimes entered into on a when-distributed basis before the distribution takes place.

When-issued. A short form of “when, as, and if issued.” The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All when-issued transactions are on an “if” basis to be settled if and when the actual security is issued and the exchange or National Association of Security Dealers rules that the transactions are to be settled.

Window. A term applied to a place in the office of a broker or dealer where securities are actually received or delivered.

Window ticket. A term applied to a document given to the broker or dealer by a transfer agent as a receipt. Also applies to a transfer document originating with the brokerage concern (broker-originated window ticket).

Wire house. A brokerage concern that has a network of communications (telephone or teletype) that links the main office to branch offices and offices of correspondent brokerage concerns.

Wire room. See *order room* and *order department*.

Yield. The return on investment that an investor will receive from dividends or interest. The return is expressed as a percentage of the current market price of the security, or, if the investor already owns the security, of the price he paid. The return on stocks is computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bid.

Commodity Terms

CFTC. Abbreviation for Commodity Futures Trading Commission. An agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants (FCMs). Among other things, this agency establishes rules governing the minimum financial, reporting, and audit requirements of its members. Its function is similar to that performed by the SEC in regulating brokers and dealers in securities and various securities markets.

Commodity hold out. Commodity transactions on the broker's or dealer's records that are not reported on the clearing house sheets.

Commodity spreading. Implies open purchase (long) and sale (short) contracts in the same commodity or in different commodities.

Contract difference. The difference between the contract and the market values of commodities.

Forward market. Reference made to non-exchange trading of commodities and securities at a future date. Contracts of this nature are designed by both the buyer and seller as to delivery time, amount, and so on.

Futures contract. A contract for the purchase or sale of commodities at some time in the future.

Half turn. A transaction involving the purchase or sale as an opening transaction. (See *round turn*.)

Point balance run. A listing of each future commodities contract by month of contract on which the extended contract value and market value are indicated together with the resulting gain or loss.

Round turn. A purchase and a subsequent sale or a sale and a subsequent purchase of a commodity futures contract.

Variation margin. A term used in commodity operations that refers to last-day point fluctuation—difference between the prior day's settling price and the last day's settling price—on net positions long and short.

Government Terms

Forward contracts. The sale or purchase of GNMA securities transactions on the Chicago Board of Trade at a future date. As in the case of normal commodity transactions where delivery is made with warehouse receipts, GNMA transactions are cleared with the delivery of due bills.

Fungibility. GNMA securities transactions are interchangeable as to interest rate and pool and are traded and settled at an equivalent yield basis.

GNMA. Abbreviation for Government National Mortgage Association. GNMA modified pass-through certificates are bought and sold on a current or delayed settlement date basis.

Interest trades. These transactions, as defined, involve (1) a purchase of GNMA securities for current settlement, (2) a delayed settlement sale of these securities or the possession of a long standby, and (3) a financing of the long GNMA position by a sale under an agreement to repurchase on or before the future delivery date.

Optional commitment. A call exercisable at a future date. A long optional commitment is an option to purchase GNMA securities; a short optional commitment is an option to sell.

Optional commitment fee. Amount received or paid for the sale or purchase of an optional commitment.

Standby. A put exercisable at a future date. A long standby is an option to sell GNMA securities; a short standby is a commitment to buy.

Standby fee. Amount received or paid for the sale or purchase of a standby (approximately 1 percent to 1 1/2 percent of the principal amount).

Striking price. The price at which GNMA securities can be purchased or sold upon the exercise of a standby or optional commitment.

TBA. Abbreviation for future GNMA pools "to be announced" that are bought and sold for future settlement. "To be announced" refers to interest rates and due dates that are determined at a later date; trading in these securities is done on a yield basis.

Up-front fee. Amount of cash paid to a delayed settlement TBA or GNMA purchaser that is offset by an increase in the sales price.

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